

## Pearson Preliminary Results 2002

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### **Marjorie Scardino - Chief Executive**

Good morning, everybody. Thank you all for coming and for being willing to sit and listen to us talk about our review of 2002, and our view of what 2003 is going to be like.

Here are the financial highlights. Most of you will have already seen these highlights. Rona is going to take you through them in detail very, very shortly. I don't want to steal her thunder, but let me just tell you what we think these highlights mean, what they mean to us. First of all, they mean that we made our financial goals. We've produced the earnings' recovery we promised; we generated more operating cash than we ever have; we improved our return on invested capital which, as you know, includes the goodwill of our acquisitions in the transformation of the business we've done over recent years. That transformation really is now beginning to produce some benefits.

Secondly, it means that we made our business goals. This result represents an improved performance for all three of our major businesses. We took significant market shares in four of our largest businesses. We had modest gains in almost all the others. And each of our businesses is now best in its field, and each of our businesses has the ability to sustain that market-leading position into the future.

We're in good shape, we think, to continue this level of improving performance next year, and beyond next year. For 2003, just to start out with outlook, we are confident that, except in the most extreme political and economic environment, we can make further significant earnings growth, even at current exchange rates, further progress on cash and return on capital. And beyond this year, we're confident we can make annual progress in all three of these areas.

So, Rona is going to go through with you now the details of 2002, as well as some of our policies for tracking and reporting going into the future. I'll turn it over to her.

### **Rona Fairhead - CFO**

Thank you, Marjorie. As Marjorie said, we delivered underlying top-line growth, with Pearson Education and Penguin performance more than offsetting the downturn in business advertising. Margins have improved over the past year, benefiting from our cost reductions and from the lower losses on our new businesses. We've delivered a better-than-ever performance on cash and returns, with cashflow ahead of previous years and strong cash conversion. And we're making real progress on the working capital reductions we've been targeting.

With our portfolio changes essentially complete, driving our returns up beyond our cost of capital is a key focus for us now. In addition, we've strengthened our balance sheet with a reduced level of net debt.

Before I go to the numbers themselves, I just wanted to say a few words about our financial reporting. We are aiming to improve the clarity of our accounts. This is much easier to do today, as our major portfolio changes and our start-up internet investments are complete. Firstly, you will see many of the resulting middle-column items fall away. Secondly, as you will know, our internet businesses are fully integrated with our core. So, we will now present our numbers on one post-internet basis. But we have disclosed some of the internet details for 2002 so that you can track our progress on delivering the commitments we made. Thirdly, we've included some clear reconciliations of our business performance to the statutory accounts wherever we feel they will aid a better understanding of our underlying business performance.

We've also tried to give you more consistent sales and operating profit breakdown across all our businesses. And in recognition of the fact that Education represents around two-thirds of our business, we are providing a clearer breakdown of Pearson Education profits, in particular. And just to note, although our numbers present underlying growth, which excludes the impact of both portfolio changes and exchange rates, for 2002 with our portfolio largely stable, 'underlying' essentially means 'at constant exchange rates'.

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So, let's turn to the details now of 2002. Underpinning the group's growth was Pearson Education, up in double digits. Sales of the FT Group continued to fall, although IDC provided some relief. Penguin delivered above market growth.

Turning to profit, we improved operating profit on our continuing operations by some £67m, representing an underlying improvement of 18 per cent. This is after a £20m increase in pension charges, which is a one-time adjustment up to harmonise our US funds, and after expensing £30m integrating our back offices in our book businesses. We took those straight through our P&L, and this charge on our integrating back offices was split roughly £20m/£10m between Pearson Education and Penguin.

We state these numbers after our normal operating restructuring costs, which we take straight through our operating P&L. We have achieved solid progress in all three businesses. But you really have to look behind the numbers to see what's going on. So, let's start with Education.

As I mentioned, we're trying to give greater transparency. Going forward, we'll provide sales and operating profits for all three of our global segments: Schools, Higher Education and Professional. 2002 demonstrated the benefits of having the breadth of our Education portfolio. The key elements were: firstly, a fantastic performance from Government Solutions and Certification, two elements of our Professional business that both benefited from a dramatic spike in federal contracts; and a great market-beating performance from our Higher Education business. These were offset by a slower year in Schools, which we were expecting and a continued decline of around 15 per cent from our other main Professional business, which is Technology Publishing. Our Corporate Training business (FTK) continued to struggle in a very tough market; sales were down 18 per cent.

Operating profit improved significantly, up 22 per cent. This improvement was largely due to reduced losses in both the internet and FTK. We integrated our Family Education Network business into our core. We cut costs and we reduced our internet losses by over £50m. At FTK, we remained in loss, but we cut that loss in half. We have now sold part of that business and reorganised the remaining businesses. This sale will result in a £40m, essentially non-cash, non-operating loss.

Excluding these, our Education profits remained flat, with margins down just over 1 per cent, which is in line with the guidance we gave at the half year. The two driving factors were, firstly, the impact of these back office consolidation and pension costs, which I've already covered, and, secondly, business mix. So, let me give you a little bit more detail on the mix.

In 2001, Schools represented nearly 50 per cent of our sales, Professional around 20 per cent and Higher Education around 30 per cent. In 2002, Higher Education remained constant, Schools fell to 40 per cent as we sat out some adoptions and open territories were down a little, and our Professional businesses grew to 30 per cent, driven by the double-digit growth, as I said, in Government Solutions and Certification.

Looking at margins, School margins fell around 1 per cent, or £27m. The US Basal publishing represented almost all the fall, yet even here our margins were still at 18 per cent. Secondly, our US Software sales are down a little, but we reduced our losses to very small single-digits. And our US School Testing business grew a little and maintained margins at around 15 per cent.

Within Professional, underlying profits grew 7 per cent, or some £6m, but margins fell to 10 per cent, almost entirely due to two things. Firstly, the worldwide technology publishing margins reduced from 15 per cent to 10 per cent, so still in double digits, but on 15 per cent lower sales. Secondly, Government Solutions grew the top line in double digits, but on margins of 10 per cent to 12 per cent. On Higher Education, we drove margins up above 18 per cent overall, with our US College business improving its 20 per cent plus margins. And remember that these costs absorb the £11m of pension charges that were allocated to Education and those £20m of back office costs.

Turning now to the FT Group. At the FT Group, sales fell 8 per cent, or £75m. The advertising recession hit all of our business publications. Recoletos fared a little better, boosted by the relaunch of its sports newspaper. And although IDC delivered good growth, this was not enough to offset the overall decline.

FT Group profits were up 8 per cent. We radically reduced our internet losses from £60m to £34m. However, excluding this reduction, our profits were down to £114m, from £132m last year, as all our

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business newspaper profits fell. At the FT newspaper, although we continued to drive down costs, these measures stemmed but could not fully offset the advertising recession. The FT made a £1m profit versus £31m last year, with profits in the first half being largely offset by losses in the second. Of these second-half losses of £6m, approximately 50 per cent relate to one-off property charges. The Economist and Recoletos bucked the trend as they benefited from significant cost reductions they undertook in 2001. And IDC continued its enviable track record of growth, up 12 per cent on last year.

Moving on to Penguin. Here, sales rose 5 per cent, well ahead of the flat market. Operating profit improved at a double-digit rate as we committed. DK returned to profitability, and but for the back office rationalisation costs, the profit improvement would have been 20 per cent.

Our adjusted earnings per share (EPS) of 30.3p represents an increase of over 40 per cent, and we raised the dividend by 5 per cent. The interest charge you see reflects our significantly lower level of net debt, following the RTL disposals in January last year. And our tax charge, which is now reported under the new accounting standard, FRS 19, is just under 33 per cent.

Clearly, these results have been affected by the movements in the US dollar. As we said at the half year, a \$0.05 change in the dollar for a full year affects our earnings by about a penny per share, or £12m operating profit, up or down. This holds true going forward.

To complete the statutory P&L performance, although our reported EPS remains negative, this is almost entirely due to normal, non-cash goodwill amortisation, and it represents an improvement on 2001. The goodwill charge itself reduced significantly, largely due to the absence of impairments and the beneficial impacts of exchange. In 2003, we expect the amortisation charge to reduce further to around £260m. Integration costs were £10m. I'll cover these in a moment.

Our position on non-operating items is much improved, down £180m on last year. Finance costs improved by £38m, even after the one-off charge of £37m to close out various swaps. This charge is the direct result of the RTL disposal in January of 2002, and we disclosed it at the time.

And on tax, you'll remember that last year's number included a number of tax credits totalling some £100m. We released a further tax credit of £45m in 2002 to deliver a P&L charge of £64m.

As I said, integration costs fell to £10m, in line with our commitment. We expect no further integration costs from the acquisitions we've made. This is the way you see that we've progressed on integration charges over the past few years, as we've made a series of acquisitions. Clearly, we view the cash impact as importantly as the P&L. You can see here how the cashflow has moved, and we're expecting only a modest cash outflow in 2003.

Keeping with cash, this remains a real focus for us. While we've been increasing our progress on cash every year since 1997, we're operating our businesses more on cash and capital efficiency now than ever before. Although we've covered over £20m of additional catch-up pension payments for 2001, which you can see in the other movements, we still improved our operating free cashflow to £305m. This comes from an £18m improvement in our operating cashflow, with cash conversion of 92 per cent, well ahead of our 80 per cent target, and over £50m from lower interest charges.

Our significant progress on managing capital has been crucial. We've held CAPEX to the level of depreciation and will continue to try to do so. We managed year-end working capital down to 19 per cent of sales, from 21 per cent. During the last six years of transforming our company, our net movement of funds has been generally negative, and where positive has been largely driven by disposals. In 2002, for the first time in six years, we're paying down debt out of operating cash. Going forward, we expect more cash to flow from our business.

Let's stay with working capital. We made a commitment to reduce absolute levels of average working capital by 5 per cent, or about £40m, assuming constant sales. And we are delighted with the progress. We delivered over £50m reduction in cash tied up where it matters, at Pearson Education and Penguin, our users of working capital. It is here that we focused our attention and where we installed the incentive plans to encourage our people to deliver. This represents a 5 per cent reduction at the absolute level of average working capital, or over a 1.5 per cent improvement of average working capital to sales. And we're particularly pleased that we continue to invest in

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increased author advances and increased pre-publication spend, which are our new product development.

Even with the lower sales at the FT Group, it contributed even more in 2002. One thing we have learned is never to create a working capital target linked to constant group sales, when all of the working capital is in two of the three business. The sales downturn at the FT Group affected the group ratio. In 2003, we will continue to focus here and expect further modest improvement in our book publishing businesses.

So, our balance sheet is now in good shape. The disposal of our stake in RTL, which is principally the £685m movement you see in other net assets, lowered our net debt to around £1.5bn. We reduced that a little further through our focus on cash and ended the year at some £1.4bn. The other major movement was in our operating provisions. Provisions obviously represent charges that we took in prior years through the P&L and the movement downward represented a cash impact of spend against those charges. The key cash outflow in 2002 were pensions, which had a net effect of some £22m, and I'll come on to talk about pensions more. And cash spend on provisions on our acquisitions, integration and internal restructuring amounted to some £30m.

As I said, I'd like to spend a moment to cover pensions. We obviously take our commitments here very seriously. What we focus on is the actuarial valuation and the resulting cash demand on Pearson. Our UK fund, at £1bn, is by far the largest and had a small surplus of some £43m at the last full valuation in 2001. Of course, we're required to do a full valuation every three years, so our next one is in 2004. We ended our contribution holiday on pensions in 2001 and started to charge our P&L with a 17 per cent contribution rate in the UK. We also have some smaller defined benefit funds in the US and Canada, but outside the UK most of our people operate 401-Ks, which are essentially defined contribution plans, so that the cost to Pearson is largely that of matching those contributions.

So, here we show the pensions' impact on Pearson. In 2001, the P&L effect was £35m, as we took a credit of £5m from the UK surplus in our P&L. In the UK, there was no cash impact from the cashflow to fund contributions because these did not occur until January of 2002. These are the **catch-ups** that I referred to earlier. In the rest of the world, the cash and the P&L charges match, as you'd expect.

In 2002, in light of the equity market deterioration, we elected not to recognise the £5m surplus, and we took this one-off hit in the US when we harmonised our funds there. So, our P&L charge rose to £54m. The cash outflow in the UK was £38m, which covered both 2001 and 2002 contributions. The full cash outflow was a £74m plus £7m for post-retirement medical benefit schemes, which was the £81m number that we gave to you last year.

Looking ahead to 2003, we again will not recognise the surplus in the UK. Moreover, we've increased our contribution voluntarily by £5m, creating effectively a 25 per cent contribution rate. This should cover our funding needs aimed at maintaining a fully-funded actuarial position, even in the current market. Obviously, our future contribution rate will be formally set in 2004 after our next full valuation.

As you know, we're also required to disclose the funding position under FRS 17, and here it is. The impact of FRS 17 is broadly similar to SAP 24 in P&L terms. The FRS 17 deficit is largely unchanged year-on-year in the US, as we only have a small DB scheme there. In the UK, the deficit has increased from £51m to £149m on an after-tax basis. But clearly, the FRS 17 deficit has no direct impact on our cash.

We have several priorities, in terms of the way that we measure performance in Pearson. One of the areas that we're focusing on, as I said at the beginning, was our return on invested capital. So, what I want to do is spend a little bit of time in saying what our thinking is here. We're using a pretty tough definition of return on invested capital, which has the benefit of simplicity. Essentially, we take our operating profit, less cash tax, which we assume at 15 per cent (this is the maximum that we've paid in the last five years because of our NOL position in the US, and is one that we feel comfortable with in the next short term), divided that by the sum of our net operating assets and growth acquisition goodwill. During our transformation, we obviously sold low-growth businesses and replaced them with higher-growth ones. Typically, these have a pay-back of three to six years. We, therefore, expected and saw a deterioration in ROIC in the short term. The key is to ensure that the returns improve, and improve beyond our cost of capital.

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The good news is that the group returns start on the upswing in 2002, with returns on invested capital improving from 4.6 per cent to 6 per cent. So, how did we get there? On the returns side, as you see, operating profits improved. On invested capital, gross acquisition goodwill reduced due to our RTL disposal and some currency benefit. We also reduced our level of operating assets.

Going forward with our portfolio change essentially complete, we have two main levers to improve returns: operating profit and net operating assets. In terms of operating profit, it's about how we perform in our markets, taking advantage of our leading position and about realising the cost advantages of our integration programmes. Marjorie will cover our agenda on these in a moment.

On the asset side, we'll continue to focus on driving down average working capital, balanced with the need to invest for future growth, and we'll also keep tight reins on our capital expenditure. But clearly, we won't be focusing on just one measure. We need to continue to drive other elements of business performance. As Marjorie said, we expect to deliver good earnings growth, even at the current exchange rates, and also improve cash generation strongly every year over the next few years. We will continue to maintain our balance sheet strength. And with all these, we will continue to deliver improved returns.

So, let me now hand you back to Marjorie.

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### Marjorie Scardino - Chief Executive

Thank you, Rona. Let me now go through with you each of our businesses, in terms of our agenda for them for 2002 and 2003, and our outlook. How do we see their market shaping up? How do we see their businesses shaping up?

Let's start first with the biggest, Pearson Education, which last year accounted for 64 per cent of Pearson's revenues. Our operating agenda for Pearson Education last year was different for every single division, but overall we aimed to do a couple of things. We aimed to take advantage of our sheer breadth of this business, the fact that we work across all markets, cradle to grave, pre-school to professional and we use our financial headroom, created by that breadth, to really increase our market share across the market. That's what we were trying to do last year. The second thing we were trying to do was to combine content and services more, to expand our range of products and to expand our range of markets.

You can see, I think, the success of that agenda in the revenue growth that we achieved in Pearson Ed last year. It was the first year that our Education operations grew in double digits, thanks to our performance in College and Professional. It was also the first year we achieved something we've been working on for a long time and that is to generate as much out of services as we did out of publishing. We didn't get there, but for the first time, more than 30 per cent of our Education revenues came from services last year.

Just to help you keep in mind the shape of Pearson Education, this is its make-up relative to Pearson. So, let's take a short look at each one of these categories of Pearson Education. First, let's go to the largest, which is Schools. In total, this business is about 26 per cent of our company. It includes School and ELT (English Language Teaching) revenues from around the world. These businesses are very important, especially as Asia grows, especially our ELT business, which grew very well in 2002 to just over \$200m. We expect to increase the size of that business by about 50 per cent by 2007. So, to about \$300m. And we're going to take a good step towards that in 2003. But the majority of our School business, some 75 per cent, about \$1.35bn is in the US School business. Of that, 65 per cent is publishing, making margins in the high teens, 35 per cent is split pretty evenly between Testing, which makes margins in the low teens, and Software, which we expect should make margins in the 15 per cent range when its product portfolio is full.

Our School business last year worked on three agenda items. Our first goal was to gain share profitably in US School publishing. Let me go into a little bit of detail about that. In 2002, as I think you all know, total sales on all instructional materials in US Schools were around 5 per cent lower than they were in 2001, about \$3.6bn. Of that \$190m fall, \$100m was due directly to the fact that the value of the new adoptions out there to go for was lower than it was in 2001 - not because of budget cuts, but just because that's the way the adoption calendar flows. Open territory spending was down a little bit then as well, a percentage point or two. All of that produced lower opportunity for everybody. On top of that, Pearson only competed in some 65 per cent of the total adoptions. So, \$220m less than we competed for in 2001 because we didn't think those adoptions were going to be profitable for us. Looking at 2003 on this chart, as you see, the trend reverses a little for the market. It's up about \$30m, and a lot for Pearson. What we're going for is up \$140m.

In 2002, our aim was to do three things. To hold our share in open territories at about 29 per cent. We did that. To make sure that in the adoptions we did compete in we did well. We did that too. We took \$0.36 out of every adoption dollar, as opposed to the \$0.30 per adoption dollar we took in 2001. And this approach meant we lost a little share, but we didn't lose very much. We lost about half a point, and we sustained our margins at around 18 per cent. For 2003, our agenda is pretty clear. We need to hold our ground in the open territory states, which we are very confident we can do. And after making a lot of investment, especially in the social studies area, where we haven't been for a decade, we need to go out and make the sales in these bigger adoption competitions we're entering. And we're doing that. There's still some way to go, but we're feeling good about our year so far. As you know, especially in Texas, which is the biggest adoption state this year, they report earlier than usual, and we think we're doing pretty well. Texas is spending \$230m on new social studies programmes. That money looks secure; it will be spent and we are doing well getting our share of it. Elsewhere in

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Florida, Georgia, Virginia and California, we look like we can meet or beat our own expectations that we had at the start of the year. We are watching state budgets carefully and watching state spending carefully. California is a concern. We are seeing a few delays there, but other than that, the adoption states are spending. There is a little softness in open territories, particularly in the Mountain states, which are thankfully fairly sparsely populated. But one example of expenditure in an open territories state, the state of New York, for example, announced a headline cut to its education budget of about 8.5 per cent. But spending on instructional materials was untouched. So, it's good to remember that materials comprise only a point and half of the total state budget, but those are not where the cuts tend to come. So, what we're doing in this adoption world is worrying a lot less about funding and a lot more about doing as well as we possibly can in these key adoptions. As I said, we're feeling in pretty good shape that we can recover what we conceded last year in market share, small though it may be, and be a little bit better than that.

Moving on down our Schools agenda, we didn't completely achieve our goal of making our Leadership and Online Learning pay. Our revenues were down 10 per cent to \$220m, still a pretty heavy business, but that was mainly due to one customer in California who deferred a plan to purchase. Our Enterprise and Curriculum Software sales held up pretty well at a time when school districts were holding back on major purchases, partly because of budget pressures and partly because they're all waiting to see what requirements are going to be on them for the 'No Child Left Behind' legislation, and what sort of expenditures they have to make. We did make good use of this time. We completed our integrated Student Information Instruction service, now called Concert. You will remember it, perhaps, as NTS for School. And we reduced our ongoing cost. We successfully launched Concert in November. We've already sold installations to about 17 school districts, and in 2003 we expect Concert to really begin to count. It is increasingly being paired with our other online programmes, and we expect them to sell well too.

Our third agenda item was to build on our Testing lead, and we did achieve that goal. In 2002, our School Testing business had a pretty steady year, up about 3 per cent in revenue, after 13 per cent growth in 2001. But this was a very successful year for us. We renewed major contracts with two of our biggest state customers -- Ohio and California -- among a number of other state renewals. And we renewed and expanded our contract with the Federal government to make the only national, American school test. And we won a lot of new business, including an extra contract in Florida, some brand new contracts in six other states. We upped our win percentage of contracts 50 per cent over 2001. We now have a 54 per cent market share in the US School Testing business. The benefits of all these contracts will start to kick in this year, and we expect to see the level of revenue growth for that business begin to gain momentum as states move toward the 2005 date by which they have to test every child, every year, under the NCLB legislation.

Moving on to our professional business, which is 19 per cent of Pearson Education. This was the agenda you see here. The first item was to protect margins and the technology business which we did. Consistent with our technology publishing businesses around the world, revenues in the US side of the business fell by a further 12 per cent on top of the 20 per cent they had fallen in 2001. We cut back costs radically. We reduced headcount by 20 per cent and we kept our margins in double-digits, although down on the previous year. And we did gain a point or two of market share. We will continue to do this kind of thing as we look at the fundamental prospects for this area of publishing. We are the market leader. It is a good business, but it may be changing somewhat.

Our second goal was to make corporate training profitable. And on that we did not achieve what we set out to do. Corporations didn't increase spending on training and development and we didn't get an increased share of what they did spend. So at the beginning of this year we completed the sale of that business, which was a part of FT Knowledge. FT Knowledge did have two businesses that fit very well with the rest of Pearson and have good profitability and good prospects. We have kept those. The New York Institute of Finance, which for 80 years has been training financial community professionals, is now part of the Financial Times and does well with its brand. And IMC, which provides bespoke web training and had been working with our government business for some time to do some of those government contracts, is now part of that division.

Our third goal was to expand our certification business. We did that, this year starting our contract to provide professional exams for nurses and we also added clinical pathologists to our list as well. In

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case you don't remember, this is the business that provides testing and training and final certification for a lot of different professionals, IT professionals, medical professionals and so on. The results for this division, this year mainly reflect the fact that they opened 200 testing centres to fulfil these contracts. The revenues began to come in, in the last part of last year, and this will be their first full year of having those centres opened, having the nurses on stream and some of their other contracts going.

Finally and significantly, we aim to and we did exploit the surge in US government spending and testing and training. In addition to multi-year contracts we already had with the government, most of you will remember that we, last year, won one large one-year contract, which is worth over \$300m, which was our work with the new transportation security administration to recruit and test 64,000 security personnel for US airports. I hope you are all feeling more secure now that you know we have done this. We have done this well. It was the largest peacetime recruitment drive in US history. We did it in six months and we did it at a lower per employee cost than had ever been achieved by any agency. So this is, I think, a testament to the operational power of this business. It was a large one-year contract and it looks pretty unlikely we can match that kind of revenue spike as it generated for us in 2002. But we will come closer to replacing the profit. I think the important thing to understand about this business, though, is that there will be big contracts from time to time, but this business is no 'flash in the pan' business. Government spending is going to be the fastest growing area of the US economy in 2003 by a wide margin. The federal government announced it is going to transfer nearly half of its civilian jobs, about 850,000 jobs, to the private sector over the next 10 years. Many of those jobs are jobs we really excel at, like testing, certification, data management. We have already signed \$300m in new federal multi-year contracts which begin in 2003. They are part of our total roster of contracts, which stands at about \$1bn. Those contracts have an average life of just under 4 years. And there is a steady stream of other contracts to go for. We have got right now, about \$250m worth of contracts in the bidding or evaluation stage. We won't win all of those contracts, but they are just an indication that there is a lot of opportunity to go for and a lot of steam in this business.

Just to digress for a minute while we are on Government Solutions. It is one of the businesses that we bought with NCS, and all NCS's businesses are now completely integrated into Pearson Education. But we said we would note the stand-alone progress of the company through this year and here it is. Helped by the performance of this government business, NCS delivered a 50 per cent increase in profits in 2002 on top of a 48 per cent increase in 2001. Although we have more modest expectations in 2003, partly because of that big contract I talked about, obviously we are pretty pleased with the performance of this business in spite of the economic downturn. NCS continues to outperform its acquisition model and as a result it is ahead of schedule for clearing its cost of capital and moving on to produce a larger return. How fast that is going to happen is dependent on several factors. But the fact is that even if this business were to be flat in 2003, we would still be producing our 15 per cent average growth that was in our acquisition plan. So as I say we are very pleased with this acquisition.

Now moving on from all of this to a slightly less complex business. Our US Higher Education Agenda for 2002 was pretty simple and that agenda holds true for 2003 as well. As Rona said, this business had a fantastic year. It achieved all its goals. Its sales were up 13 per cent; its margins were 22 per cent. If you include Pearson in the number, the industry grew at 10 per cent. The rest of the industry, without Pearson, grew at 8 per cent. The Higher Ed success was due to three main factors. First it was due to being integration free and integration successful. After we bought Simon and Schuster, we had a lot of work to do to integrate all of our imprints, all our publishing lists, all our sales forces. We performed pretty well through all of that integration. But this was the first year completely without those distractions, and it really showed. We restructured the Addison Wesley business, aligning the editorial and sales. But centralising all the functions. And that really paid off as well and helped lift Higher Ed to the heights it reached. Its business is now matching the high standards set by the market leader, which is its sister company Prentice Hall.

The second thing that really helped us achieve this level in this business was our technology. We are ahead of the market in making technology an integral part of our college programmes. Customers are rewarding us for that with increased adoptions. We are able to sign a lot more professors to author books because of our capability and innovation in this area.



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And the third thing that really helped push us along was our custom publishing business. This business is well ahead of our competitors. It grew 50 per cent last year. It is now three times the size of any of our other competitors businesses and this is the future. Helping professors fashion their own course materials into a book. This is what people want to do. So this business is going to help us as well. In fact, technology and custom publishing together helped us take market share not just from our competitors, but also from the much talked about used-book market. Retention rates in our business - that is the proportion of backlist sales of a title that we make, compared to the sales we make in the copyright era - retention rates increased from 60 per cent to 63 per cent this year, which was a good outcome.

As far as our outlook is concerned. In the college publishing market, we are expecting as you might imagine more modest growth, around 5 per cent to 7 per cent in the market. But we expect once again to do better than the market. We have a good list. We have a well functioning company and we think we will achieve that.

So overall, for the Education business this is our outlook. Our US professional operations, especially Government Solutions, will do well. But because of our one-off contract in 2002, they will likely be down on revenue. We expect Higher Ed to do better than its market, as I said, and we expect our US School operations to return to growth and achieve growth ahead of the market. After an 11 per cent underlying revenue growth in 2002, we expect that our total revenues because of this one spike may fall. But profits and margins will benefit from a shift in the revenue mix and the actions we have taken to reduce costs. So the profits and margins will rise next year. That is our outlook.

Now let's move on to the FT Group, which this year accounted for 17 per cent of our sales. The FT Group is made up of the Financial Times, all the business newspapers and magazines, as well as Recoletos and interactive data and our associates, namely The Economist. Living through the worst advertising recession in 50 years, I am sure you have heard that a lot, but that is definitely the reality that we face. The FT's performance was far from its peak in 2002 and far from what we would have liked. Its profits were down £100m since 2000, that has had a major impact on Pearson's earnings as you know. But its P&L downturn doesn't reflect any loss of market share or any loss in sales or in readership. Over the last 2 years, the ad volume decline has tracked our competitors and each of our local papers has had a similar downturn, but still sustained their share.

At the same time that our business newspapers and magazines were suffering, in the FT Group two businesses were not affected by the corporate gloom: IDC and Recoletos and they had strong years. So let's look at our progress against our 2002 agenda for the FT. And that pretty much remains our agenda for 2003.

First costs. We obviously concentrated hard, but carefully on tight cost control. The newspaper's 2002 operating costs were some 11 per cent lower than the previous year, about £23m. The combined costs of the FT's print and on-line businesses are 25 per cent lower in 2002 than in 2000. That's about an £80m cut in the cost base. To achieve that, we did a lot of things. We cut headcount, we cut variable costs across the business, the editorial side did its part. It has had a budget unchanged for the last couple of years. In our other business publishing operations, we did the same kind of things. As a result, the FT paper, Les Echos and FT Business were all in profit despite drastic reductions in advertising revenues in 2002.

In 2003 we will make more cost savings. At the FT, we have identified further incremental savings and yet in all of our newspapers are working on some more. But we are going to use those cost savings to invest in the FT publishing businesses, to take advantage of the market and our position for the future. We also did well in 2002 in our goal of making online investments pay. That is something that is on our agenda for 2003 as well. All our online operations are fully integrated in the FT. We tracked FT.com. It did breakeven in the fourth quarter, in line with our target. It did that by reducing costs, but it also did that by increasing its revenues. Its new revenue source, subscriptions, will be a positive addition to revenues in 2003.

FT.com has also done something else very, very important and powerful for the FT. It has expanded its reach. FT.com now has an all time high, 3.5m monthly users and that number has grown rather than shrunk as we have started charging. And even although a large portion of the site is now behind

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the subscription firewall, that number continues to grow. That certainly helps us with the next item on our agenda, which was to build our region brand. This is a pretty tough thing to do, build anything in a time of falling revenues and spending and confidence. But we think we have made progress on this last year.

The FT's average circulation fell back last year from 490,000 to 470,000 mainly due to lower sales in the UK which isn't much of a surprise when a downturn hits the city as hard as this one has. But the size and quality of the FT's readership is strong. According to the most recent EBRIS figures, the FT audience actually grew in 2002 and it remains by far the most widely read business title in Europe, with upscale readers.

That trend has been repeated in our other papers as well. Les Echos had a circulation fall of 6 per cent, much, much less than its competitors. FT Deutschland actually bucked the trend. Its year-end circulation is up 14 per cent and its main competitor circulation is down 8 per cent. And the quality of those papers' audiences also remains second to none.

All that gives us confidence that while the ad environment is pretty bloody, our international proposition is unchanged. So we intend to keep costs steady. We will adjust downward in some cases, but we are going to invest in others and we are going to continue to build our international audience. We are going to start in our home market, in building the FT. In April in the UK, you will see a revamp of some sections of the weekend FT and in the weekday paper we will make some changes. And we will back this with the first advertising campaign we have had for the FT in 4 years. I guess if we can't believe in advertising, how can we expect others to? In the US, we are going to invest in building our subscriber base and we are going to drive our overall circulation in a more measured way. We think an ad recovery will definitely start in the US, so this is a pretty important priority for us. We are also going to launch in a modest way, an Asian edition, starting with a Chinese language service on FT.com. We are going to relaunch Les Echos in the autumn, with a new format, more colour, more printing options so that it can be much more attractive to advertisers.

As I said, we are funding all this very modest investment through the cost savings we have made. We will phase those through the year as an added protection if we need them. But we do think this is very much the right time to protect and extend our international position and our market share.

Our agenda for the two parts of the FT Group, IDC and Recoletos, which had excellent performances in 2002 and look good to deliver that again in 2003, are pretty much more of the same. Cost savings and a Marca revamp helped to increase the profits in Recoletos by 21 per cent. And they will continue to develop along those lines in 2003. And Interactive Data. Interactive Data is now 31 per cent of the total FT Group. They had another great year, sales up 10 per cent, 28 per cent margins. They are going to keep on doing in 2003 what they do best too. IDC's success is due really to three main factors that keep their renewals and their institutional business, which is 90 per cent of their revenue, going at about 95 per cent. Their renewal rate is about 95 per cent. What they have is first must-have products. Products that are really inside their customer's infrastructure and integral to what they have to do. Secondly, new products. They have been very good at keeping a close relationship with their customers, figuring out what their regulatory requirements are and coming up with new products for that. They're Fair Value pricing product that they came out with at the end of last year is very, very popular with regulators and therefore the customers as well. The third thing they are very good at is moving carefully, prudently into new markets and increasing their breadth. They will have that with their new integration of Comstock, which they recently acquired, which will take them into front office, real-time data.

So what's the outlook for the FT Group? With all this going on, a terrible business advertising market, what can we predict? It is pretty difficult to predict in the business and political world we are in now. But let me see if I can talk about this in a way that may help you understand how we are thinking about it. In the second half of 2002, we lost about £3m on the FT. That takes out those one-time real estate costs in Rona's £6m. In the first two months of the year, revenues were down a bit, in the 5 per cent to 10 per cent range from what we expected. As the spectre of war has gotten bigger and bigger and stock markets have gotten softer and more skittish, we have seen and we expected that. But our costs are very much lower as well. 25 per cent lower as I said than in 2000 and we got a bit more scope in those, we have got the modest investment space and we have some protection there.

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Obviously if there is a war, if there is some great cataclysmic event, we can't predict what will happen. But it is important to remember that in the FT Group, the total FT Group is only 20 per cent of Pearson. And the FT Group is more than the FT; it's all our local papers, which while falling are doing much less bad than the FT. It is IDC and Recoletos, which plan to do well this year. And the FT Group as I said, is only 20 per cent of Pearson. The FT's advertising is less than 5 per cent of Pearson.

So in that context, and given that we have taken so much costs out since 2000, we think we are in a reasonable position to weather just about any eventualities other than major ones.

So let's move on to Penguin. This, last year, accounted for 19 per cent of Pearson. With sales and operating profit ahead of its market, Penguin's financial performance in 2002 reflects pretty good progress on the agendas that they had. Our agenda for 2003 is the same for them as well. Here is a reminder of what those agenda items are. Rona has already talked to you about working capital, so let's talk about the other three.

First, bestseller performance. That is crucial to the success of this company. In 2002, we had more number one titles in the US than any other publisher, a 25 per cent improvement on 2001. And we had our best hit performance in the UK for a decade. As a result, we took share in both of those markets. In the UK, according to Book Scan, the total market was flat; our two closest competitors were down 9 per cent and 6 per cent. Penguin was up 4 per cent in the UK. In the US, we grew 3 per cent in dollar terms. Borders and Barnes & Noble, which are about half of the retail book market, reported that their stores sales were flat to down, so we are sure we gained market share in the US too.

In 2003, we are going to grow faster than our major markets once again. To do that, there are four things we really need to get right. First, new books. We need to get new books right. We have to publish the best books and we have to do that where we can on a worldwide basis, because that is where we have the maximum leverage. Our record is pretty good on that. And as an example, if you missed it today we announced that we have the international rights to publish five beautiful children's books by Madonna. The first one comes out in September. They really are very beautiful books and we think that they are going to do well.

The second thing we have to get right is old books. We have the biggest, most successful backlist in the industry. That plus our re-launch of Penguin classics, which you will see outside helps us push beyond our competitors because they don't have that advantage.

The third thing we have got to get right is our new categories. We are concentrating on some high potential categories more than ever. Travel we have always concentrated on, now we control 100 per cent of Rough Guides and we can move that on. And the children's market through both DK and Penguin is a good one for us.

Finally new imprints. We have created some great new imprints, headed by distinguished editors like Anne Godoff, who joined us from Random House earlier this month. And her new imprint is going to publish its first books around January. They are going to bring some exciting authors into the Penguin stable as well. And in the new imprint, new category line, our just new this year business imprint had three of its first four books on the bestseller list. That is an amazing achievement for business books, so we think there is great promise in that new imprint.

The second item on Penguin's agenda was to make DK profitable and we did that in 2002. DK grew its top line by an underlying 8 per cent and delivered a 5 per cent margin. It's profit of £8m was a £15m improvement on 2001 and at the same time we made the plans and we made the investments to take it higher towards Penguin margins in 2003. DK has a lot of advantages now to help it achieve this. It has got sales and distribution strength. It has now got purchasing clout. It's complete consolidation with Penguin of all but its central editorial and design functions help. And above all, it has got going for it a revitalised publishing programme. So we think it can't lose.

The third item on our agenda was to save money from consolidating functions. We did some of this in 2002 and we will do a lot more of it in 2003. The fact is that the opportunities for many of these improvements to operations move to a new much more valuable level because we are now by a long way the world's largest book publisher as you see on this chart.

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Across Pearson Education and Penguin we have been able to make significant P&L investments in technology and in these integrations and still show material improvements in operating profits. It seems as if we have been talking about back-office integrations for a long time. We have. And we have been doing them for some time. So we have already consolidated our business services in IT in the US, outsourced our US and UK data centre operations, consolidated UK business services for all of our businesses including the FT and including warehouses, outsourced our IT and software development. All told, this work involved one-off net cost of £30m in 2002, which was expensed through the P&L of Penguin and Pearson Education. And it will involve a further £20m next year. We are starting to see these cost savings come through, small at first - £5m last year, more this year. And big enough to offset the costs next year. But 2005, this work will really start to add to the bottom line with £20m in annual cost savings.

So our confidence in all of this supports our outlook for Penguin this year. It's top line growth may be a little bit slower than in 2001 but still ahead of the consumer publishing industry which predicts a growth in low, single digits at best. And we expect another year of strong profits growth underpinned by the margin improvements at DK and the first benefits of all of our integrations.

So that's a run down on all our businesses. I hope that all this information encourages you to share our confidence that our strategy is going to produce yearly progress so that for 2003, we will show significant earnings growth again this year, even in current exchange rates. We will show further improvements in free cashflow again this year. And we will show continued improvement upward on our return on invested capital, up to what we think the quality of these businesses should produce. How quickly we can move our returns ahead does depend in part on the economic cycle and in part on the timing of an ad recovery, but no one should doubt the direction we are headed in and no one should doubt how hard we are willing to work to get there as quickly as we possibly can.