Pearson

# United States Higher Education

## Investor Seminar 10th June 2003

### Marjorie Scardino

**Chief Executive**

Oh thanks everybody for coming out. This obviously reflects a shortage of things to do in the city today, so we really appreciate your coming out.

This is the third in our series of seminars about various parts of our business. We've done the School business, so please no questions about the School business at the end of the day.

We've done IDC and we have done these on the 10th Floor where the view is much nicer and the place is much nicer. But if you remember last time, as the CFO of IDC was explaining guidance for his earnings he collapsed on the floor, so it wasn't a good message. We thought we would move lower down in case it was vertigo or something and we could improve on it.

Today we're talking about United States Higher Education. This is a $1b business. Worldwide our Higher Education business is about $1.250b and so that extra $250 is our International business. We have the biggest Higher Education business of all the American publishers internationally. But we're really going to focus today on Higher Ed in the US.

The FT and Schools get all the headlines all the time, but this is a great business and in fact, in 2002 it was the biggest contributor to profits in Pearson. About 30% of Pearson's profits were due to Will Ethridge's group Higher Education. Don't let that go to your head though.

It is about a 34% market share our US Higher Ed business. It produces about 20% plus margins. It's steady, reliable growth. It's fuelled by some very good demographic trends, a booming college aged population, widening earnings gap between high school graduates and college graduates, so more desire to get that college education a shift that you all know about from the manufacturing to a knowledge based economy.

It's also a business that is very important to Pearson because it can make a lot more in cost savings as being part of Pearson and use a lot more of Pearson's channels. It can drive it sales through our school channels or our college channels, our retail channels, or international. So it is really a very logical and helpful part of Pearson and it has partnerships all around Pearson with Penguin, with the FT. It creates new products all the time with other parts of the company.

So to talk about this more is Will Ethridge. Will is Head of Higher Ed business. He has been in publishing his whole life. He looks older than he is. He's actually only about 35 but he looks in his 50s. He has been doing this about 30 years and he joined Addison Wesley in 1986 as an Editor. He stayed in Higher Ed publishing then. So you've got to think he knows by now what he is doing.

He has steered our company through the biggest integration in the education industry. That was our acquisition of Simon & Schuster. At that time he kept us growing well ahead of our competitors and this past year, with the integration behind us, he really showed us what a powerhouse could do. We grew at 14% against an industry that was growing about 8%.

Will has really managed some of our toughest management challenges all around the company, but he is so good we recently made him Head of International and we've given him the worst management challenge of all because now John Fallon reports to him. I can never do anything with John Fallon, but I'm hoping that Will will do better and I'm hoping he will be able to handle all of you to, so I'll turn over to Will now.

## Will Ethridge

### Chief Executive, North American Education

Thank you Marjorie. What I want to do today is really leave time for questions, engage a conversation with you, but before I get to questions I want to cover really two points in this presentation. The first is why we think the industry is a good industry; why it is stable and growing and second, what we think are Pearson's clear leadership advantages which in short are that we have great breadth of content, we have the largest and most powerful sales forces, that we add value through innovative programmes through the use of technology and custom and finally, that our scale gives us pretty considerable cost advantages.

Now Marjorie talked about knowledge economy and the importance of education. I've got some statistics here worth noting. 10 years ago only about half of the high school graduates went on to college. Now two-thirds are going onto college. They recognise that in today's world a higher education degree is a necessity and we also see that the income differential between high school graduates and college graduates is going up. It has gone from 50% to 80% to maybe 100% difference. So it's clear now that to succeed in today's world you need a higher education degree.

But in addition to just that phenomenon, we also have a nice demographic surge for this decade. Basically, you've got the baby boomers kids who are now getting to college age and this decade the rate is basically going to surge of baby boomer kids going through it. So that's a good thing.

And the last thing is that higher education is no longer just for the 18 to 22 year olds. You have adults that go back for retraining and an economy that's all about creative destruction and change. You have people constantly going back and you also have, in US higher education, a steady flow of foreign students and immigrants. So you have a lot of trends that are going on that make higher education very attractive right now. Plus, it's recession proof. In many ways it's mildly countercyclical. Often you've got more people going back to school for retraining in the tough times. So it's stable and this decade should have very good demographics.

Here are overall industry sales. We're using gross sales and management practice data because the AP figures sometimes don't really account for acquisitions very well and returns can be very seasonal while gross sales are much more predictable. So we look at really gross as the way to measure market share.

And basically, in terms of price and units, the industry has been raising prices about 4% or so. The underlying growth over the last several years has been 7%. As Marjorie said, 2002 was a great year for the industry. The industry actually grew about 9 to 10%. But when you take us out of the industry it was our 14% against everyone else's about 8%.

This next slide is a simple schematic of how we sort of make money – what the sales process is. I'm going to talk more later about how we focus on the Professor, which is really the key. Let me talk a little bit about bookstore buying behaviour and student buying behaviour.

Bookstore behaviour doesn't impact us very much except in the odd years when they buy too much. They misjudge enrolments and they have too much inventory out there and then the next year what they tend to do is not buy as much. They constantly try to fight us on used books and value packs, things like that, but that's sort of built in. So that really the only way to really impact us year-to-year is if they mess up their inventory planning. But other than that, they're sort of a predictable, stable element in the chain.

So it's really about do we get enough adoptions and then can we get the student to buy the book. One nice thing about college publishing is unlike school publishing (I know there is a lot of concern now about school funding and government cutbacks and all that), we're really not that impacted by that. I mean the student buys the books. The only way we potentially could be impacted is if the cuts in higher education means they cut sections, or if they raise tuition and we're going to see a little bit of that, but we still think that the industry is going to grow a very healthy 5 to 7% this year. Maybe without some of that it might grow a little bit more, but we still think that it is going to grow a healthy 5 to 7%.

In the competition for student purchases we compete with used books and in this pie chart you can see that 62% of the total market consists of new text books, but that we lose a pretty potential market share loss of 25% to used books. Bookstores and students largely favour used books and the Internet and the scale of the bookstore chains have made the used book market highly efficient. But that's sort of built into our numbers now. There was a period in the '90s as they bought up all these bookstores that became more efficient. But now, used books as a percentage of the total have really sort of levelled off. It's not a growing problem. It is what it is. They get as much supply as they can and so the problem is not getting worse. They've made their market as efficient as they possibly can.

In addition to new and used, a small portion of the market doesn't use text books or use lecture packs or trade books.

Now let's talk about Pearson's market position. As Marjorie says, we're number one, but in 1998 we were number four. Pearson, Addison Wesley Longman and with the purchase of Prentice Hall and other higher education properties from Viacom Pearson transformed itself into the leading higher education publisher and since the acquisition, sales have increased to almost $1b. During that period, we grew a compound annual rate of 8% versus the industry growth rate of 7%. One of the reasons we enjoyed a very strong year in 2002 was because we had all the integration stuff behind us. We could be totally focused on the business. We didn't have the building cannibalisation that you get from integration. We had a very successful integration and that's well behind us now.

Here's how the share breaks up among the major text book competitors. We're the clear market leader and we operate in an industry that is now highly consolidated. Our two closest competitors are Thompson and McGraw and similar to Pearson, they have also grown largely through acquisition.

College publishing is a highly competitive business. It's very hard to get big significant swings up or down in market share and there have been only really two major exceptions to this trend. First, Prentice Hall in the mid to late '90s grew faster than the industry due to organic growth and more recently, Addison Wesley has been growing faster than the industry due to organic growth and both Addison Wesley and Prentice Hall are Pearson companies.

Now our goal is to outperform the industry by a point or so on a consistent basis. This slide basically shows, and again this, as compared to AP data which doesn't really factor out acquisitions, this factors out acquisitions. It shows true underlying growth. So you can see Pearson's growth in yellow versus the industry during those four years and really, we're flat to equal the industry in 2000 because that was the first year we got the hit of all the cannibalisation. '99 really didn't because the sales were at ... the two companies had all been separate and then starting 2001 we grew some more and 2002 we grew some more. So we feel that our goal to consistently outperform the industry by a point or so is doable. We obviously did a lot more than a point or so in 2002. I don't think we can do that every year, but I do think we can grow by a point or so and I'll explain in more detail about why we think we can do that.

One of the reasons we think we can do it is that we have two great companies and this is where we differ from our competitors. What most people do is they throw all these companies together. You get a lot of disruption. You lose relationships that Sales Reps have. The lists don't reflect publishing vision. They're just sort of hotchpotch of throwing this stuff altogether. What we did is we said it's important to keep two companies. We want to have more Reps than the other guys, we want to have a better book bag and we want to be able to optimise our portfolio across the two companies and it's a big reason why we can outperform.

Now the first company is Prentice Hall. That's a leading name in college publishing and it publishes across the whole curriculum and it consists of four publishing divisions supported by college publishing's largest and most respected sales force.

Addison Wesley Higher Education is a little bit more of a boutique publisher and what we did there is we took these four imprints and all of them at one time had been operating separately. We put them one under umbrella and so you have Addison Wesley and Venture and Cummings which are great companies in the quantitative sciences, in the life sciences and then you have Allyn & Bacon and Longman that are great companies in the soft side. We have one soft side sales force and we have one hard side sales force.

What this does is we basically could focus them under areas of strength and then where they weren't strong we said get out of that area and we'll just have Prentice Hall do it. So we had two companies going after the markets where the markets are vibrant and growing which can support two companies and where the markets are slow growing, or in a combination of high investment we only have Prentice Hall going after it.

Another advantage we have is we have a very diverse safe portfolio. We're basically number one in almost every single discipline. So we're not leveraged if student interest changes. Sometimes more people take computer science and more times people take in education. We have a very broad base and also by having two companies we're really able to place the books where they could sell the most. So we don't have a sales force that has too many books in one area and then not enough in the other. We really optimise it so they have real presence, they get some real scale, but they still have room to grow.

Now I talked earlier about a basic process which is Professors, bookstores, students. Most of our focus is on the Professor. The way it works is they adopt the book, they tell the student listen, I'm going to assign this book, we will test from it, students will buy it. Professors are much more important in terms of student buying behaviour than price and we found that actually price has very little to do with student buying behaviour. If the book is not central to the course you could price it really low. You can price it at $40 and students are still not likely to buy it. This is only reference, not really using it. If the book is priced at $90 but they're really going to use it – you're taking organic chemistry, you want to be a doctor – they'll buy it. If you're spending thousands of dollars to go to college it makes sense to spend $70, $80 for a text book that's used for the whole course. But if a Professor is just using it as background it doesn't make sense to pay $70. So we've really focused our pricing and our publishing to make sure the Professors are really using our text because if they do, then students buy them.

And as I said before having two companies we have two chances to get the adoption. We have two chances to sign up the next great author and then they work with customs. So we like the fact that we have two chances to get the business while McGraw Hill only has one and Thompson only has one. But we know that we have to leverage our scale. We have to leverage the Pearson advantage and let me talk about some of the ways we do that.

I'll talk about each of these individually, but these are the basic ways that at the Pearson level we support the publishing companies. We have programmes that help us drive share and improve retention. We increase sales through multi-market reach. It's not just international; it's high school and professional. We can drive down cost with scale advantages.

Then, because we have two companies and because we have this central group that makes sure that good ideas flow through the company, we have a built in organisational expertise advantage. What would it be like if you could look inside the window of your competitor? You know exactly what was going on. That's what it is like for Prentice Hall and Addison Wesley. I make sure that the minute someone has got a good innovation the other company gets it, which puts relentless pressure on them to come up with the next innovation because they have to keep innovating because they know when they get some – if Addison Wesley figures something out, then Prentice Hall is going to get it. Addison Wesley figures something out, vice versa. So they have learned to accept it. We've got good people, but we can really scale good ideas and this is a great, great advantage.

Let me talk about some of these programmes in a lot more detail. Custom publishing. Pearson is the leader in custom publishing, the clear leader in custom publishing, and we think custom publishing is a trend that is going to continue.

There are three types of custom publishing. There is what we call original material, which is simply Professor has some notes, they may have some third party content, what we do is give them some editorial advice. We get the permissions for them and then we print them the books.

The second is database publishing where we have databases that go online. This is especially popular in business cases, readers, lab courses where they can go and they can customise their own reader, their own set of cases, their own lab manual and then we print the book for them.

The third and fastest growing form of custom is what we call derivative custom, which is really a blend of all three in a way. They have their own material. They can have the syllabus of the course in the text book. They're going to have their assignments and then they can pick and choose from Pearson titles what they want and really customise. So instead of saying okay here's your syllabus on the first day of class, here's your book; the syllabus is in the book. Instead of saying read these chapters, only those chapters in the book and Professors like that. You have shorter books, we can price them differently and it has been a big growth story for us.

And you can see the growth story. In 1998 going into '99 we were number two behind McGraw Hill and one of my goals that I set out was we're going to be number one and we invested more in custom. A lot of people worry about the margins of custom and we think actually the margins are pretty good, so a lot of people didn't push it as hard as we pushed it.

One of the reasons that the margins are pretty good, yes it's true that your manufacturing costs as a percentage of your price or sales are higher, but you have lower returns and I'm not talking about financial returns; I'm talking about unsold books. Because a Professor is really using this book, they're testing from this book, more students buy it, so your returns are lower and also you don't have as many used books. There is not a national supply of used books. It's only that Professor's and we try to make these custom books as much as possible something that are active. You write in them, you use them. So it's not there is not that big massive amount of used books that are out there. So yes, it's not as good in terms of margins on manufacturing, but it's better in terms of sell through over a three year period.

Another growth driver has been the use of technology and value packs to not only gain share but to address the used book problem. Now value packs are basically bundles of two or more products. In some cases they're print bundles. They could be the text with the study guide. But increasingly, they're bundles of text with media. Text with technology. In fact, technology now accompanies almost all our text and with introductory text, technology is really a vital component of the overall package.

Now some of our technology is just free. It's a way we use it to gain adoptions. Students can access it whether they buy a new book or buy a used book. But increasingly more of our technology can only be accessed if you buy a new book, or if you buy a pin code. So you can have a used book, but if you buy a pin code. Basically what we're doing is the way it works when I went to college, you basically got a text book, you read it or didn't, you went to class and you got tested and you got maybe tested depending on the instructor once a week, twice a quarter whatever. Now what's happening is you buy the text, you read it, but then the instructor gives you homework online. Built into the online is the homework, tutorial help, you can go to a tutor centre. We have things called Research Navigator which helps you do research. It's all there. The Professor has course management. He can get the results of how they're doing. So the Professor has advantages too.

Before, he would assign the stuff, he would never really know who was learning it, who wasn't. He would test. But now what you can do is you can find out that night, that day, well listen, these students are having trouble with this particular concept. In economics they're having trouble with the difference curves. I had better spend more time on a difference curve in my lecture. So both students and Professors like the fact that they can have the assessment content, tutorial content, extra resources online. So you read and study and then you go onto the web, or CD, and practice.

In those kinds of technology we're saying you've got to buy the new book or you've got to buy the pin code.

We also have a competitive advantage. Most of our competitors can only put their content within the generic WebCT or Blackboard. They're the two major course management systems out there and we work with WebCT and Blackboard. But we have a unique situation. We have what's called Course Compass which is basically Blackboard with our own proprietary tools. So what it really means is a Professor doesn't have to do as much work. If you're using a generic, you've got to load the content, or get a content cartridge which is very hard to do it and if you're a techie it's easy to do, but mostly Professors are not techies.

You've got to then go to the publisher's proprietary testing system, to the publisher's proprietary tutorial system. What we do is we put it all in one place and one of the reasons we've done well was 2002 was sort of the first full year where all that work had been done. And we have what are called MyMathLab, MyEconLab. They were all these sort of Course Compass enabled products and definitely Professors will say buy the book and the students will buy it because they know they're going to be tested from it. They know that they're getting assignments.

And so we can see the result that as we focus on this, as we've come up with real ... and you've got to come up with real value. You have to be innovative. You've got to come up with technology solutions that really add something. We've had a very nice rise in the growth of value packs and as I said, value packs help us drive share. They also help us with used books.

Now the way we measure the impact of used books is what we call the retention rate which is basically a ratio of a book's first year of sales with its sales in the second, third and fourth years. For years that ratio – you know when I started this business – it was like 90% because there wasn't a very efficient used book market and it went down, down, down, down, down. For Pearson it went down to about 60%. Now it's starting to go up and it has gone from 60% to 63%. So we're monetising more of a market share now.

Now another way that Pearson adds value to Prentice Hall and Addison Wesley is our books can sell outside of the US college market and let me give you some examples. There are three basic markets they can sell outside of – high school, international and professional retail. Professional retail is generally limited to computer books and business books. Let's talk about high school first.

We sell about $55m of college product in the high school and that's basically primarily AP. So it's basically students and AP is growing very rapidly. So it the same books that they're using in college and they get in high school advanced placement college credit. Here's an example of Campbell, which is the best selling introductory biology text in colleges. Campbell is also the best selling text in AP and then we did a special new Campbell that's for the Basel high school programme. So this is a great example of how we leverage our intellectual property to create three Campbell's. Plus Campbell is a best seller internationally.

If you look at retail we have a company that reports to me called the Pearson Technology Group. It's a leading professional computer publisher. They have their own sales force. We're also the leading computer science academic publisher. We have a very strong business publishing unit.

So this sales force will sell those college products that have appeal in the professional retail market. So for example, you have a book here by Harvey and Paul Deitel, by far the number one book to learn programming languages if you're a Computer Scientist. It's also the AP best seller if you're a high school student who wants to get advanced placement credit in computer science and it's also a best seller on Amazon, Barnes & Noble because professionals use it and buy it to stay abreast of what's going on in technology. So it's another example of Pearson's multi-market reach.

The third market is international. We sell over $200m US of college products, US college products, internationally. Here you have an example of [Carllor], a classic in marketing. It's the number one book in US college. We have adaptations of its in Canada, the UK. In some places we bring in local examples. It has been translated in 23 languages and we have numerous examples of books that are truly global brands.

We compare ourselves to our competitors. No other publisher has the same multi-channel reach. Yes, Houghton Mifflin has a very strong school division, but they don't have a professional computer sales force, so they can't sell in professional retail and they're far weaker internationally. Thompson is stronger than Houghton Mifflin internationally; not as strong as we are; but they don't have a High School division so they can't really go after the AP. There's no publisher, with the slight exception of McGraw Hill, that is in all three and McGraw Hill doesn't equal our scale and reach.

Authors get it. I hope shareholders get it, that if you publish a book with Pearson, with Prentice Hall and Addison Wesley, not only do you get the best sales force in the US you have a better chance of getting sales in high school, in retail and in international. That's a big deal for authors. They say I want to sign with Pearson because they can do that.

So I've been talking a lot about all the programmes that we're doing to drive sales, but we're also focused on the cost side. We basically said to the publishers listen, we're not going to over-manage you, we're not going to blow your relationships with Professors and authors; but we're going to centralise everything else and we've been driving a lot of cost out of the system. We have one back office. We have one technology group. We have one custom group. We have consolidated all of our paper in printing purchases. We've consolidated all of our systems.

You know a lot of time with integrations people move slowly. We said okay, we're going to let you publish but we're moving right now to move to one set of systems. I remember Addison Wesley saying to me well our systems are better. I said well I don't care. We're moving to one. There are more Prentice Hall people then there are Addison Wesley people. Let's just get on with it. Don't worry about systems. Worry about publishing.

So we've generated tremendous savings and you can see the results. Addison Wesley Longman which had margins of about in the high teens, which is the industry standard, now have margins that are in the 20s along with Prentice Hall. Now with international coming into my group we can do the same kind of things and extend our economies globally. So I think we have more room to even drive more costs out.

This slide lays out what I see as some of our key opportunities and challenges. A great opportunity is that we are number one in the basic skills areas. That’s like freshman composition, it’s remedial math, it’s college math. Whether in university, whether in vocational, whether in a community college, everybody is taking these courses. In some respects, our high schools are not doing such a good job of teaching basic skills. But you also have the immigrants. You have more people who normally didn’t go to college. In fact, you have tremendous growth in community colleges and vocational schools. They’re taking these courses and Pearson is number one. So we are just going up with that rising tide. We’re by far number one in freshman comp and in developmental math.

We are also increasing investment and reorganising ourselves to grow share in allied health and nursing. We’re not going after the medical side, the doctor side, but we do think there’s a good opportunity in nursing and allied health. We like being the small guy there. We don’t have the arrow in our back. We will put the arrow on Reed’s back, on Delmar’s back with Thompson and we’re taking our success in that area and saying look, we’re going to invest here. This is a natural. We have the sales resources to go after two year in vocational. That’s where a lot of these courses are being taught. We’ve got that infrastructure. Let’s just get more books. Let’s have more Reps and we’re going to take share from the people who have it right now in allied health.

Finally, the biggest challenge and opportunity is continuously figuring out how we can add more value through the use of technology and custom. As I said, students will buy the book, Professors will assign the book if there is real value there. You have Professors who didn’t grow up with technology, you have students who did and there’s a real divide. If we make it truly easy, if we continue to make the assessment linked with the content, that’s a programme that we can scale across the whole portfolio. That’s the way that we can continuously outperform the industry and again, we have the resources in our central technology group, but more important, we have two companies trying to figure out technology. We have two companies trying to figure out custom and we think this dynamic organisational expertise makes it more likely that we can continually stay one step ahead of our competitors in terms of the use of technology and custom.

In summary, and then we’ll get your questions, we’re the clear leader in a stable industry that should benefit from good demographics and growth in the years ahead. This is a very strong defensible position. It’s really hard to go out and make relationships with lots of Professors. This is a hard industry for somebody to break into. It’s a lot of tactical stuff. You’ve got 700 Reps out there, all these Editors, it’s very hard to get into our business. So a very strong defensible position.

We expect to consistently outperform the industry in sales growth. Every now and then you’re going to have industry doing very well like it did last year and every now and then you’re going to have industry going below. But it’s a very predictable 5% to 7% and we see ourselves about a point ahead of that and due to our scale economies, we think we can grow profit percentages a couple of points higher than that. And if we’re getting threatened, we can use some of that mix to also invest more than the other guy. So we have the flexibility to drive share and profits.

So thank you for your attention. Now I would be pleased to take any of your questions.

# Question and Answer Session

**Marjorie Scardino**

Everybody, we're doing this on the web so we're going to ask you to have a microphone even though it's a tiny room and you don't really need a microphone, but we're sending it out are we not Luke? So we need your help and I think I'll stay up here to protect Will.

**Will Ethridge**

Okay. You can tell me which questions I can answer and I can't answer.

**Matthew**

Hi, we're familiar with the seasonality and the working capital issues in K12. Can you just talk us through what the position is with College and also maybe what the economics of the text book are in terms of an author advance? Do you have to throw a great deal of money at people like Anthony Giddens or whoever, or is this actually less of a star culture?

**Will Ethridge**

Okay, in terms of the seasonality, we're very seasonal. We're second half. So we spend money in the first half in terms of our Reps in getting the books out there and we get the money in the second half. We're probably more seasonal than most in that it's really July. Start getting indications July and August and then our biggest month actually is December. Marjorie always says are you going to make it? And I say well it's a big month you know. The bookstore decides to get the order in at the end of December versus the first week of January. It can be like 10 million in one day. So we're very second half.

In terms of working capital, we don't have big advances. Our working capital is generally tied up in plant and inventory and again, we're working very hard to use our scale. So inventory we've actually done a very good job with lower month coverage. We're getting these purchasing power savings. We're also focusing on plant and leveraging our knowledge in media and some other areas to lower the cost down there. But those are the two areas where we ... it's more like school publishing in terms of plant but not as much as school. You know, we have a more diverse. There is the big introductory. We have the big introductory text and then we have a lot of upper division books that don't have much client.

**Marjorie Scardino**

Just to put a little bit of colour on that, it is in fact so dependent on authors who are Professors that what our college sales team does is also sign up authors. They get commissions for signing up authors and authors are not from Harvard necessarily, but from East Carolina State University and therefore, they don't get big advances but they sometimes write really winning books. Campbell was a good example of that.

**Will Ethridge**

Yes.

**Marjorie Scardino**

So it's not a star quality thing.

**Will Ethridge**

Most books don't get an advance. Every now and then in certain fields, we basically for most markets will have three books. We'll the sort of the Harvard level, we'll have the middle and then we'll have the very low level. Every now and then in certain areas...

**Marjorie Scardino**

Also we'll go to Yale.

**Will Ethridge**

We have to pay advances like in economics or something to Greg Nanke or something, or Paul Krugman kind of thing, but it's very rare.

**Marjorie Scardino**

We gave Tony Giddens $1.50.

**Matthew**

Actually just on the issue that you raised in terms of tuition fees and how that might affect things, I mean we're looking at some colleges it seems more in the public sector than the private sector having increases of 15% or so. How does that affect spending? I imagine people prefer to go to eBay than necessarily go into a new bookshop and have to spend $70.

**Will Ethridge**

As I said, the used book market is already really efficient. I mean they don't have to go to eBay to get a used book. They've got people standing outside the bookstore telling them there is a used book. They've got their friends and actually eBay in some respects is inefficient because they want to wait until the last minute, you need the book right there, is it going to get there or not? So that's really not an issue, the efficiency. So definitely an issue.

I was talking to some people earlier on. Some students will buy the book no matter what. Some students won't buy the book no matter what and then there are people in the middle. There may be some people in the middle that say hey I don't have the money. But as I said earlier, it's really much more about whether the Professor assigns it or not and it's not as much about price, which is good.

We're more protected because of those things. They buy the book and they're very sensible; they'll look to see if the Professor is really using the book or not.

**Matthew**

Are tuition fees they're a bigger issue this year than last?

**Will Ethridge**

There's a lot of smoke about this and in a lot of places it still hasn't been solved yet. So yes, I mean at some level if tuition increases go up a lot you could see some impact, especially at the community colleges. There are some students who want to go to college but it has now become harder for them to do so. But the demand is so strong that people generally find a way to get the funding to go to college and even though they're raising tuition at these community colleges, you're talking about from a very low base. I mean they have kept it so low, so it's like maybe $500 a semester to $600. I mean if you can come up with $500 you will probably come up with $600 and in many cases for new colleges the demand already was greater than supply. So in some cases there may be some people not going, but now they'll find it easier to get into class. A lot of them were having trouble because demand was so strong getting into the class. So there could be some impact. I don't want to say there is no impact, but it's nothing at all like school publishing.

**Unidentified Audience Participant**

Can you talk a bit more about the international opportunity? Is that mostly margins, or do you see a lot of growth in different parts of the world?

**Will Ethridge**

It all depends. There are different parts of the world where there is growth. Canada right now is a good place because they have got this double cohort group which means that sort of two classes will go into college at the same time.

Right now I have to spend more time to figure out what the real growth potentials are by area. I mean there will certainly be opportunities in terms of margins. We can be more efficient about how we manage our content across the groups and there will probably be growth opportunities in terms of that what I was talking about sharing organisational expertise and that will be easier to share that organisational expertise. So things that have been working in the US we can have work internationally and vice versa. I think that knowledge, what's hard to quantify, does impact sales.

**Unidentified Audience Participant**

Can I also ask, just remind me, you said Thompson has one sales force and yet you have two. Are your margins similar because you've got two companies each with similar margins?

**Will Ethridge**

Yes, the way most companies are organised, including ourselves and we have one difference is that you generally have Reps who are specialised in one area but you have only one set of Reps going to any customer. We also specialise our Reps, but in the vibrant areas, we'll have two Reps, two Editors going after the customers and going after the authors.

Our margins, I don't know exact margins of Thompson, but our margins are very good and I would be shocked if their margins were better. We get so many savings elsewhere. I wanted to have more Reps than the other guy and I can find it. I wanted more Editors than the other guy. That's not a big cost when we get some of these savings elsewhere. We're driving costs out so much elsewhere.

**Unidentified Audience Participant**

You mentioned that you might have two Editors going after authors. Is there a danger that you're competing? You've got the two businesses competing against each other and therefore bidding up the author's advances? How does that work?

The second question was just on testing and assessment. To what extent are there opportunities here? How big is that already, if at all, or is there any opportunity particularly with NCS?

**Will Ethridge**

On the first question, we can obviously control what our Editors do and so they have guidelines. It's unlike other competitors where we can't control and say you're acting stupid, you're desperate, you don't have much market share. So we let them compete, but they know they have to make these financial benchmarks and that's a self-controlling kind of thing. If they feel they're going to offer more to the author it makes sense and they have less plant, that's for them, but they have to stay within the financial benchmarks that we provide.

And what was your second part of your question?

**Unidentified Audience Participant**

Really it was just on the testing and assessment, to what extent you're involved in that business.

**Will Ethridge**

I think it's a very big focus. We have our own proprietary testing system. We have tutorial systems. We're also beginning to work with NCS in getting their expertise in this stuff. Because we're Pearson we can go out and do deals better with outside groups. We can go to Blackboard and say listen, let's do a private label. They wouldn't do that with someone else because they know it helps them.

So I think we have more organisational expertise. We can spend more because we're bigger and we have in-house expertise in terms of just Pearson in general. Pearson is very focused in assessment.

Pearson is a leader in assessment. So we think that can be a big competitive advantage for us. Marjorie.

**Marjorie Scardino**

If you just look at the value pack that he described and you saw something called MyMathLab on it, that's a good example of the kind of testing we'll have. It's embedded assessments. So that's a great programme and it has been incredibly popular because it allows students to practice what they learn and that's been really effective in getting them to learn. So that we can do with embedded assessment I think better than anybody else don't you? So we use that as a platform.

**Will Ethridge**

Exactly.

**Unidentified Audience Participant**

Good afternoon. I've got a question on returns. Could you tell us what has been happening outside of the custom business and what sort of patterns there have been and if there is any scope to improve on that?

**Will Ethridge**

Returns have been over a long set of months are very predictable and so over a rolling 12 month period they're very, very predictable and they've been sort of around the same for a while.

You can have differences from month to month and year to year. In some cases bookstores will return books earlier in the year. In some cases they will return them later in the year. I have never quite understood it. I think it is sometimes they're rolling out different programmes. So during the year you can have differences. That's why I was talking about the statistics. End of December some times because the seasonality of when they get back their returns and cash management. So over a 12 month rolling they're very predictable. Within a year you can have some wild swings and then you can also have swings when companies go through integrations where when you first go through an integration you get your sales out there in the warehouse but that you take longer to process returns, those kind of things. So you can have those kind of internal things and for all those reasons, returns can jump from month to month but not over a 12 month period.

**Unidentified Audience Participant**

Can you give us an actual number for that?

**Will Ethridge**

Generally they're in the mid 20s. 25% of your gross sales.

**Patrick**

Can you tell us a maybe a bit more about the competitive dynamic? I mean Thompson has been buying in the college area. What does a company like John Wiley say, what does it do in order to attract authors? You talked at one stage about both Prentice Hall and Addison Wesley taking share for different reasons. Prentice Hall is a general publisher. So how was that achieved? Is there a natural cycle in Professors? Do they die? Do their courses wear out? Is there a natural sort of replacement opportunity in the market through which you can grow if you like? So what is the pitch that these other publishers are making and what are their opportunities maybe to come back?

**Will Ethridge**

I think with authors the pitch is really – there are a lot of elements but let me talk about three. One is I'm your Editor, I understand what you're doing. It's a very personal. I'm a good Editor. I'm known in the industry. I will give you really good editorial attention. I know the market, all of that.

The second is you're joining a list that you respect. You're joining a list that fits into and that's why we want to keep two One of the problems when you have one is sometimes you've got books that were competing, they're now on the same list and it's very hard to sign a new author because they'll say to you you've already got everybody. You've got all these best sellers. So the advantage we have is maybe Prentice Hall has the best seller. The person no way will want to sign with Prentice Hall because they want to knock that book out. We would have lost that sign, but now we can say well sign with Addison Wesley and vice versa. So we can get signings that other guys can't get because the author wants to knock out that best seller and we've gotten lots of signings recently because with one company it was just out of it. I'm not even going to consider the company. The other company could get it.

The third thing they want, they want sales. So they like the fact that Prentice Hall and Addison Wesley have the attention, but they recognise hey it would be nice to sell an extra 20% internationally and an extra 5% in high school. I like the fact that you have Course Compass. I like the fact that you can do custom. This is going to help me and it really doesn't hurt me because I want the attention. This is just added stuff.

So where they need attention, we're small. Where they want stuff and resources and scale, we have that. I really think it's the big advantage for us.

**Marjorie Scardino**

How would you sell a book if you were John Wiley?

**Will Ethridge**

Well what John Wiley does is their pitch is we're focused. We're a hard science publisher. They have sort of the two – attention and you join the right list. But they don't have the scale and resources. But then we say okay well Addison Wesley is a great name in computer science. Prentice Hall is a great name in engineering computer science. You still get that, but you get all these resources.

So what we did is we made sure that ... Prentice Hall always the great name. They were the crown jewel. What we did with Addison Wesley Longman, they were strong in some areas, weak in others. We said when you're weak, we're getting out. You've got to have that brand. So Addison Wesley was publishing lots of things. They were publishing psychology and other things and we said no, stop it. When you think of Addison Wesley you think of math, you think of the math publisher. So you could be in math, you could be in computer science, you can be in economics. These are people who grew up with Addison Wesley books. We'll have Prentice Hall. We'll have Allyn & Bacon sell psychology.

So when we did the integration we did move things around, but we focused the list where they could really grow the best.

**Marjorie Scardino**

I would add one thing to that and that is when you buy an author in Higher Ed you're not buying Tom Clancy or Patricia Cornwall, you're making the author. So the person we sign and the person Wiley signs are probably pretty much equivalent. We make the best selling author. We made Campbell a great biology title. So that's why the advances are not vast and that's why Wiley can still sign an author that has got every chance to become a great author. But we can make them a great author.

**Unidentified Audience Participant**

A few questions on the custom publishing side. Given that it represented 3.5% of that 14% growth last year, can you give us a sense of at what point is that customised growth cannibalisation given that you're taking chapters or whatever out of different books and putting them together? Is that the right way of thinking about it?

**Will Ethridge**

Well yes and no. We try to focus custom first on takeaways. So one of the ways, someone says people die for change. In some cases yes.

**Marjorie Scardino**

Takeaway is not a pastrami sandwich.

**Will Ethridge**

Takeaway means McGraw Hill, Thompson. That's internal lingo I'm sorry. Rollovers are where you have the adoption and you just rollover to the new edition. Takeaways are where you're taking adoption away from McGraw Hill and Thompson and those are very hard to do because everyone has their own lecture notes tied to their books, they've been used to it, the books are generally good. So one of the ways that we really use custom is say well shall I customise for you. We can customise it for you. That's better.

Then in certain cases it does cannibalise, but we're getting more sell through. We actually don't mind that it is being cannibalised and we try to focus custom in those areas where there are a lot of used books out there and you maybe get one year of sales and then very little the second and third year and it's better then to be customised because you get the sales over three years. So there are certain cases yes it cannibalises but we like that cannibalisation.

**Unidentified Audience Participant**

Then just on that point where a Professor really likes a section of a McGraw Hill book, you're not able to integrate that into your customised sort of project?

**Will Ethridge**

Basically not. The publishers...

**Unidentified Audience Participant**

You'd never be able to do that kind of deal where you might look across a different brand name and maybe customise a book

**Will Ethridge**

The problem is that there is no one set up to do that and the publisher has protected intellectual property, plus you want to have control. You also want to look at your authors. We have to be careful with our authors and while we do think it is okay to customise, there is still the integrity of the work. There are certain customisation that is okay and certain customisation it isn't and so we have a process that the Division President has to sign off on it. It's not just willy-nilly. So we're just not going to make our content available to some third party and say do whatever what you want.

**Marjorie Scardino**

But you would put an article from the New York Times in it.

**Will Ethridge**

Oh yes. What we do is, and it is again advantage of being Pearson, we can go out and get better deals with the New York Times, ABC, all these other media groups, research journals to collect and organise. We're a content aggregator. We do a lot of that and we have these databases and these deals and say okay well come to us instead of you doing all that. Our custom group says okay you've got this part of the book, you've got your own stuff and then here are the outside readings and stuff and we'll bring it in. That's a huge convenience for the Professor.

**Unidentified Audience Participant**

How do you price those books? You said that it's lower margin because of the manufacturing costs, but at the same time couldn't you charge a premium given that it is...?

**Will Ethridge**

You price what you negotiated. Because it's a single book there's not a natural. So you sit down and you say okay what are our costs, what is the author going to do? The author is doing work, they're going to get a royalty. They're doing work. We have benchmarks of what are acceptable custom and then we price based upon services provided.

**Marjorie Scardino**

I don't think he said that it is necessarily lower margin. He sort of indicated it's about the same because it's higher manufacturing costs but lower distribution costs and no returns and no used books.

**Will Ethridge**

The margins they've basically the same and as I said, you get hit in manufacturing but you get benefits in sell through.

**Unidentified Audience Participant**

Can I ask a couple of questions? Can you talk a bit about the costs? What percentage of your costs are fixed and variable? How much is marketing in the mix? To what extent can you drive the margins up from here?

**Will Ethridge**

I don't want to give specific costs because I don't want the competitors to know too much about my business if you don't mind. A lot of it is variable. Royalties and edition costs are variable. That's the nice thing about the business. Your fixed costs are basic. The key ones are your plant and your sale force and that's all about success. But again, we have this diversified portfolio, so there's not a lot of risk.

**Unidentified Audience Participant**

So would the sales force be over 30%, 40% of the costs?

**Will Ethridge**

Oh, not even close to that. Not even close. That's why people saying can you afford two sales? Yes. This is a highly efficient business. We've built up great relationships. No. There's a big variable cost part of this business which is nicely self-regulating.

**Unidentified Audience Participant**

Are the sales guys paid a fixed salary, or is there commission linked elements to it?

**Will Ethridge**

Fixed plus bonus. For a Rep, a big part of it is bonus. They have their salary, but they can get 30% or 40% on top of that if they goal and a lot more than that if they were to go over. So it scales up if they go over goal and they get paid for sales, and they get paid for when they help an Editor sign an offer.

**Unidentified Audience Participant**

Do you think you can drive margins up from here, or do you think your margins are basically plateauing out?

**Will Ethridge**

I think we can. The issue is we may decide though to take some of the savings and invest more in some other areas. So that's really the issue. I mean we're going to be, our basic cost structure for the bulk of our portfolio will grow at a rate lower than our sales. We now have the opportunity to jump on opportunities. If we say hey, this year there is a great opportunity to spend more on assessment, we can do that. So from year-to-year we may decide, hey, we're not going to grow the margins this year, we're going to invest to get more market share. In other years we'll say no, we've got to digest this innovation. Let's now have the proper scope a little more. So we had the flexibility to both invest for growth as well as improved margins.

**Unidentified Audience Participant**

And Marjorie, can you say anything on Schools? Have you changed anything at all with Texas?

**Marjorie Scardino**

Have we changed anything at all?

**Unidentified Audience Participant**

Is your view of kind of '03/'04 growth rates?

**Marjorie Scardino**

No. As you no, social studies was the issue in Texas. It got totally funded, though Texas did cut a couple of hundred million off the total. But social studies did and '04 will be a down year in Texas and be just about, as we have planned, which was roughly flat. So we don't have anything different in Texas to say about that. Though it was a wild ride. I don't know if you all followed. At one point 50 Texas legislators left the State, when over to Oklahoma, holed up in some holiday inn so they wouldn't have to vote on re-districting. So you've got to admit we all had fun in Texas this year. We won't do that again next year. They don't even meet next year.

**Andrew**

Thanks. Although not as big as fees, there's still quite a big government contribution to overall college funding. You say that it is the students that are actually the text book, but does the sort of cyclicality of government funding for college, does that have any impact on your business?

**Will Ethridge**

Most of the funding in college will go for not to students except for the loan programmes, things like that and I don't think those are changing that much. Other things are getting impacted in terms of monies they give to infrastructure and things like that. So I'm not saying we're not affected at all, but it's fairly minimal.

**Marjorie Scardino**

As he said, they might cut classes. So instead of having three sections of psychology, they'll have one section, or they won't it have on Tuesday, they will only have it on another day.

**Will Ethridge**

Exactly. That's the issue is cost of higher education is all about labour, the cost of instruction and if they do decide to cut too many sections, that could have some impact. But as I said, some of that is just going to mean demand that already was going to be filled anyway. So there could be some impact, but it's not nearly as much as School.

**Unidentified Audience Participant**

You mentioned the technology products and the pass codes. How meaningful is that as a percentage of your revenues and how far do you think you could take it would be the first question?

The second question is when you sell these books, particularly through the general retail channels such as Amazon and so on, how do you avoid disappointing readers who buy a book thinking it has got everything they need in it and then find they actually have to pay X amount extra in order to get the content they thought they had bought in the first place?

**Will Ethridge**

Well we have about $400m worth of value packs. Our systems don't allow exactly how much of that is tied to me, but a lot of it is tied to the new books. So most of the students are buying new books value packs and most of those value packs have some form of technology. So the great majority, off the top of my head, would be 80% and that's been growing as you saw.

In terms of letting students know, ask the Professor. He probably says I'm using this book. It has got technology. We have in the preface all the technology. Often on the back cover we let them know and they know that if they don't buy the book they don't have the technology. We also have Tech Consultants that will come the first day of class, especially the big classes, and explain and talk about the technology to the students. We're also redesigning our website. It's a general website to talk more about what is available because a lot of students don't know what is available. So we're trying to publicise the fact that there is a power behind your text book. It's not just a text book.

**Unidentified Audience Participant**

Sorry, can I just follow up on that? So if you buy a value pack, on average, what sort of percentage of revenue, what sort of percentage of the total cost is going on the book and what percentage is going on the interactive from the consumer's point of view?

**Will Ethridge**

It's all in the book. What we're saying is buy a new book and if you buy the new book it's generally embedded in the price of the book. There is nothing extra. The value we give is in the book.

If there are certain technology programmes that they are so expensive that we need to really charge more to cover our costs and the publishing team says we need to do that, then maybe it's $10 more, $15 more. Then if the student buys a used book, it is bound to have all those underlines and the torn pages, they can go either online which more of them are doing and buy the pin code and then that's price at the difference between the new book and what generally used books are sold at.

**Marjorie Scardino**

They look at it as the value pack. So they say it's a book and a pin code and maybe a CD Rom and a review book. That's why we call it a horrible name value pack because they see the value. It's up to them whether they value the book more or the CD Rom more.

**Unidentified Audience Participant**

My question is very much along the same line. Those value packs do seem to be the major contributor in terms of your growth on that side of the business. Do you see that you are leveraging a scale advantage on the technology side there in terms of advantage over your competitors?

Maybe just to dig a little bit deeper in terms of the benefits you can accrue in terms of pricing, clearly sort of retention and how does that impact your margins? And because it is technology based, is that more of a sort of fixed cost base? So as you rollout a proportion of your division which is going to be represented by essentially these interactive devices, should we be expecting a margin leverage at that point?

**Will Ethridge**

I think longer term we're not there yet. But longer term, the ideal would be that the books get even smaller and everyone has the access and we don't have to supply the regular book with all the stuff. We can only do the text and web.

When we get to that point, then we will get a nice favourable pickup in manufacturing. A big favourable impact in working capital because those variable costs will go away, or largely go away, at least in the media and technology side and the books will get shorter and length absolutely translates into those costs. But that's still a ways away. I mean five years away or something. You have to have more access, more broadband. We still have to do sort of both right now.

**Unidentified Audience Participant**

And in terms of the margins, I mean how do the margins compare on the value packs compared to the rest of the division?

**Will Ethridge**

Again it's a little bit like custom. If there is a lot of a print value pack your unit manufacturing is likely, as a percentage of the sale, going to be a little bit higher. But one of the reasons why technology is, if you don't have technology you have a simple pin code which is just in the book, then the margins are the same. So that's one of the reasons why we like technology is we don't get hit on the margins at all. But like custom, even if you have the higher manufacturing on the print side, you have better sell through. So overall, margins are not impacted by value packs.

Our margins have gone up. Our margins have gone up as we've been doing more custom and more technology.

**Unidentified Audience Participant**

You indicated there are sort of two-thirds of high school graduates going to college in the States. What do you think the natural limit is on that? At what point do people sort of say this has sort of got to a ridiculous point and the value of a college education is actually being devalued?

**Will Ethridge**

Well who can get a job with a high school degree? It's almost everything. But the United States it's competitive. I think the job market is going to get more competitive and people recognise it. I think the difference maybe between England and here is that is this whole vocational community college thing and that people are allied health. Even very low level jobs need to get some basic skills. So I think it is going to keep continuing. I think it will get to 90% or something. It's just that there are very few jobs that you can get now in the US without some kind of either community college education.

**Marjorie Scardino**

The other one is proprietary skills. Maybe you want to talk about what the University of Phoenix is for?

**Will Ethridge**

Yes. You have these proprietary schools that are incredibly fast growing and they are tapping into the fact of people who have to work, people need to retrain adults and make it very easy for them to get their education. Make it very practical and they have been growing phenomenally well. And that is another thing that is happening is you have that whole higher education in the US is getting more efficient. They're getting better about stimulating demand. I mean it was very controlled, regulated business. You know a typical four year school didn't really, in some respects are more concerned about research and more concerned about not letting people in. Let's keep the selectivity.

These community colleges are entrepreneurial and the vocational schools, they have outreach programmes. They go out in the community and recruit students. This is how you can get a better job and the costs aren't, even with tuition increases going up, the costs aren't that great. They're really not. So that's been a big chance has been the growth of community colleges and vocational schools to stimulate demand. Before, demand wasn't stimulated. If anything, it was retarded. Now it is being stimulated by these entrepreneurial community colleges and vocational schools. I think that's a difference between England and the US. Those are really fast growing entrepreneurial organisations.

**Unidentified Audience Participant**

Just a related question. How integrated is what you do with what's happening in FT Knowledge?

**Will Ethridge**

You can answer that.

**Marjorie Scardino**

FT Knowledge is really part of the FT and we, as you know, we sold most of that company. The only thing that is left is the financial training and a bit of leadership and management training and it's sold to companies. So while they bundle a lot with the FT, they don't really do a lot with Higher Ed. Although a couple of the Higher Ed sales people and Editors do work with them from time-to-time from their business list, but it's not really very much. That's a tiny business also.

**Derek**

I assume your point on community college is meshed with what you were saying earlier about the vocational training division, or part of your business. Can you say what the opportunities really are then? How big it is and would you have to make acquisitions to develop those programmes internally?

**Will Ethridge**

If the right acquisition happened we would, although we're focusing more on organic growth. I mean really it's basically we have the sales force infrastructure. It's just specialising it a bit more and increasing investment in the products. We also think that we can take some of the use of technology and custom that we've used in College, it really has been brought by our competitors in some of the health areas and part because they haven't had tough competition and take some of those strategies and bring them to that area.

It's a highly consolidated area. There's not a lot to buy. You've got some big companies and you've got some sort of small companies. A lot of them are controlled by families. If some of those came open, came available, yes we would buy. We think we can still grow without that. Obviously acquisition would jump start it, but we can grow without it.

**Marjorie Scardino**

There wouldn't be a big acquisition.

**Will Ethridge**

It wouldn't be a big acquisition yes.

**Unidentified Audience Participant**

With used books being 25% of the total market and these value packs that you talk about, why isn't that number falling quicker than what you've sort of suggested that it will fall? Why can't that get to 15% of the total market, or 10% over time? Where is the opportunity there?

**Will Ethridge**

Well if we hadn't done this it would have gone up more because they become more efficient and that 25% is the whole industry. Our retention rate increased let's say from 60% to 63%. So our share of it probably went down.

The other thing you have to is after a good year you're going to have more of a used book problem the next year because they sort of bought more books. So sometimes when people are flush and there is good years, people over-buy and more supply of books out there. So in a bizarre way also and the more we get Professors to use our books, they still sell them back. So the value pack, they still sell the books back. So at some level, unless we got completely rid of print, you're always going to have a supply of books out there.

**Unidentified Audience Participant**

It is an integrated part of it?

**Will Ethridge**

Well that's the key. As I was saying, that's the dream. If you get to a point where the book is shorter, then it's more of a workbook rather than a text and it has become a consumable, then you're sort of obsoleting supply. And we're moving towards that and we're getting there.

**Unidentified Audience Participant**

How fast? How long?

**Will Ethridge**

Well it's Professors. Like developmental math it doesn't do that. Marjorie cited MyMathLab. Actually the more important stuff is on the web and really the books are increasingly are the workbooks and we actually had, we brought our MyMathLab. This is a very phenomenal. We have some best selling books like Bittinger, Developmental Math and we generally had a retention rate of about 70% in that area. We brought out MyMathLab and we actually sold more books in the second year of this book because we really impacted the used book market and we got more share.

Now we have to make sure there is real value. In things like math it's a little bit easier because it's so assessment based and as some of these other areas like business and others move to more assessment base, then we can do it because that's really the key. It can't be simple mill. It can't just be stuff. It has to be real assignments, real programmes that they're doing. That's when you really get the pop.

**Unidentified Audience Participant**

Just the last one, the 5% to 7% market share growth and then another part you're talking about some of the incremental margin that we're going to collect we're going to reinvest back into the business. So in the back of my mind when I'm modelling it I'm thinking well if he's going to invest incremental margin I would like to see more than market share growth. I'd like to see 6% or 7%, or would be disappointed if you didn't get that kind of growth if he is investing beyond that amount of money. Is that the way that your, or management are thinking about it? How do you sort of..?

**Will Ethridge**

Yes, basically, again I've got competitors out there. I don't want to give them too many of my strategies.

**Unidentified Audience Participant**

Well were you disappointed if we saw the margin go away at only 5% to 7%?

**Will Ethridge**

I think yes. I think in general, if you're going to do a big investment that hurts, slows down your margin, or lowers your margins, or slows the growth of the increase in one year, then you should see a disproportionate increase in sales two or three years later that pays off that investment. My only point is that I have the flexibility to do that or to grow margins.

**Marjorie Scardino**

It wouldn't happen if he weren't growing ahead of the market anyway. The point is I think Will's description of the rigour with which he reviews every investment before they do it, so I think you would have to look at it being a good return or he wouldn't be making the investment anyway.

**Will Ethridge**

It also gives us flexibility to deal with prices if there becomes more price resistance and stuff. We're being very, as Marjorie said, very rigorous about driving down the cost and scaling and now that we can do it globally we even have more opportunities.

**Unidentified Audience Participant**

Can I have a follow up from that one? If you're investing more, presumably as you're becoming more of a scale game, does that mean that you're taking share from the low end of the market and is that likely to drive more consolidation at the low end of the market further down the line?

**Will Ethridge**

Well I think it's probably true we don't have exact stats. The smaller to mid sized players have had more loss of share. But there has been some which consolidates, so there is still some out there. You've got Wiley. It's family owned. I don't think they want to sell. You've got Houghton Mifflin obviously what the investment bankers want to do and you've got Bedford Freeman & Worth which is owned by the Germans. Then you've got a lot of little smaller again sort of small and again employee owned like Norton or family owned like Jones & Bartlett. I just don't see over the next couple of years properties coming on the market. Plus for Pearson and Thompson it would be hard to buy something just from antitrust kind of issues.

**Unidentified Audience Participant**

Different question actually, on the International business where do you see margins getting to kind on a three year view?

**Will Ethridge**

Well I've only had it about a month. I'm going through the strategic planning reviews.

**Marjorie Scardino**

Yes, good. Press him on that. Pin him down.

**Will Ethridge**

So you will have to wait on that one.

**Unidentified Audience Participant**

I wonder whether you could just expand a bit on why you think you outperformed so much in 2002?

**Will Ethridge**

I think a couple of reasons. First, integration was behind us. Second, that we made some changes at Addison Wesley Higher Education. We had changed Sales Managers. We had changed some executives about a year and a half before to put a new attitude. That group more than anyone, Prentice Hall was Prentice Hall, but Addison Wesley was this company that really had been thrown together through acquisitions. There was a little bit of a victim mentality. You had people who had come from Harp & Rowe then bought by Addison Wesley, then they're being merged in with Liscott Change and all those kind of things. So now you have a company that really likes their story but with a smaller than a large.

They were also very aggressive and frankly even more aggressive than Prentice Hall in really leveraging Course Compass. So those are the three things – new attitude, new management, integration was behind us and Addison Wesley did a very good job of leveraging the technology story.

**Marjorie Scardino**

So Addison Wesley grew in the 20%, 25%.

**Will Ethridge**

It wasn't quite that, but they grew a lot. They just had unbelievable. I mean Prentice Hall had a great year. They were about a point or so more than the industry and Addison Wesley was.

That's the other thing too is that Prentice Hall has been performing well for so long. Sometimes you can get a company, you can sort of just bring practices. There were obviously some practices that were brought from Prentice Hall to Addison Wesley Longman. So Addison Wesley Longman had more to go up while Prentice Hall has been at a very high level for a very long time.

**Unidentified Audience Participant**

What are the relative sizes of the two businesses?

**Will Ethridge**

Prentice Hall is roughly about $600m and Addison Wesley is about a little over $300m and you've got some incremental custom.

**Patrick**

We've seen in different businesses like [Cue and Sands] a big downturn in demand for technology based product. How have you seen that across your business and is there any sign of a pick up?

**Will Ethridge**

Welcome to my world. It impacted us a lot in College as well. That's why our growth statistics were so phenomenal because we were number one in computer science, number one in engineering. We're number one in tech trades. While we were growing overall by 14%, they were going down 15% or so. But that's baked in the numbers. We think this really started in 2000/2001. We think that's sort of baking numbers and actually can be a good guy for us because they were based on that lower. And going forward we think we're at the bottom. There are some signs that it's coming back, or at least not declining any further. So even if we were just at the bottom and it doesn't get worse, that will be a huge thing because we won't have to overcome a 15% decline and everyone else outperform. So that's a good way a good guy for us going forward, but we just don't think it's going to degrade like it did in 2002 and 2001.

**Patrick**

Save Charles asking a question, roughly, what size is that within your...?

**Will Ethridge**

Again I'll give broad base, but again I don't want to. It's big enough.

**Marjorie Scardino**

That's very helpful. That's good.

**Patrick**

Three digits rather than four.

**Will Ethridge**

You want to get this down to the last decimal point.

**Marjorie Scardino**

Is it a three digit business? Yes.

**Will Ethridge**

It's roughly around that area. A little bit less, a little bit less.

**Patrick**

Just going back to the competitive situation, where exactly do you think the antitrust limits lie? I mean for example, McGraw Hill, Houghton Mifflin, given you're at 34%, what's the big issue?

If there was such a consolidation, is that an opportunity for you in the sense there is disgruntled authors and lots of disruption and shake out, or is that a threat because they get stronger?

**Will Ethridge**

It depends on who is doing the buying. Integrations either help you or hurt you. We've seen integrations that have gone very badly. We've lost good people, we've lost authors, a lot of disgruntled people and then you take a lot of share away from people. Then you've seen acquisitions where people have gotten stronger and they've gotten more scale. McGraw Hill, when they got Irwin, got better. McGraw Hill had been weak in the '90s and when they got Irwin, they got better because they got some of those practices and they got more scale. You have other situations where people haven't done that well with the acquisition.

Marjorie is a lawyer. I don't like to answer legal questions. When the government allow or not allow, I'm not qualified to say.

**Marjorie Scardino**

It's an unanswerable question because nowadays they don't just look at current competition, they look at what it does to the future competitive landscape and so it's a lot of chicken bones and bat wings at this point. So I don't think it would answer. But I think that we, McGraw and Thompson would have an equally hard time getting by the Justice Department if we bought Houghton Mifflin, for instance.

**Patrick**

Is it your sense that because of the Avendi issues they've lost a lot of share and executives and momentum?

**Will Ethridge**

I don't like to talk too much about the competition. They haven't actually lost many executives and personnel because I think they have nice stay bonuses. So I think there is financial incentives for people that if I'm not mistaken end this summer and then the issue will be after that – will they continue to have the loyalty?

**Marjorie Scardino**

Thank you all very much. Stay and have a drink with us and see if you can corner Will and get him to answer something he couldn't answer like how big is the Tech business. But thank you all for coming very much.

[End]