Pearson interim results 29/07/02 transcript

Marjorie Scardino

Good morning. Welcome to the presentation of Pearson's results for the first half of 2002.

Thank you for coming. I'm sorry about the venue, but the prospect of crossing a picket line at the British Library wasn't appealing.

So, on to the business at hand. Although our company makes the lion's share of its money in the second half of the year, we have a lot we can report today.

Here are the main numbers:

1. In total, sales are down 3% on last year, almost entirely due to the advertising recession.

2. Operating profits are up 27%.

3. Pre-tax profit and adjusted earnings have both improved on last year, too.

But, as I said, these numbers don't give many clues to the outlook for the full year unless you look beneath them. In an atmosphere severely lacking in corporate credibility, I know when I tell you I'm confident about the year you'll want as many supporting details as you can get.

So today we'll try to dissect our results and give you that confidence in Pearson's future.

We have three main headlines:

1. In 2002, our earnings will rebound.

We're really comfortable with this prediction because:

a. The bulk of our businesses are performing very well and all of them are performing well in relation to their markets.

b. Our newer additions, particularly NCS and Dorling Kindersley, are making a strong contribution.

c. Charges that reduced profits last year – such as internet investments and interest payments – will help profits this year.

2. Our businesses are leaders in their field, and made stronger by the scale and assets and cultural advantages they get from being part of Pearson.

a. Underlying revenues in Pearson Education are ahead of last year's record start, and a good part of the business is growing faster than the market.

b. Penguin has had a solid first half and is scheduled to be even stronger in the second half.

c. The FT, in spite of the environment, is turning in better revenue and more profit than its competitors.

3. Our third headline is: We are driving our cash performance and concentrating closely on making sure our investments pay off.

To talk about this and the details of the results, let me introduce you to our new CFO, Rona Fairhead, who will go through the financial details of the first half of 2002 with you.

Rona Fairhead

Thank you Marjorie.

We said in March that we had 3 priorities:

- protect margins
- maintain balance sheet strength
- increase cash flow

We have delivered on each of these in the first half and remain on track for an earnings rebound in 2002. Let me show you the detail:

Sales were down 3%.

The driving factor was the advertising downturn which hit the FT Group. As this didn't start until Q2 2001 we knew comparisons would be tough.

The advertising-related businesses were down more than 30% year-on-year, but overall the FT Group was down just 12% on an underlying basis.

Sales in Education and Penguin were pretty much in line with the previous year.

Turning to operating profits from continuing businesses.

The big picture is that the £16m improvement results from:

- reduction in internet losses (£44m)
- offset in part by the advertising downturn (£31m)

But let me give you the detail.

For the second year in a row, Pearson Education delivered a small profit, rather than the historic norm of a first-half loss. We benefited as you may remember from a very large early learning contract and some early reading adoptions in the first half last year. This year we have benefited from our NCS Government Solutions business.

Our corporate training business FT Knowledge remains challenged but we reduced the level of losses.

The reduction in internet losses is substantial – I'll cover this in a moment.

All the FT newspapers suffered from the advertising downturn. Recoletos was a first half exception – helped by a lower cost base and an exceptional sporting calendar for it's sports newspaper, Marca.

IDC had a great performance – up again on 2001. And once again, FT internet losses reduced considerably.

And at Penguin, profit was held level against an unusually strong first half performance last year – improving margins as DK returned to break-even, but offset by a seasonally weaker first half performance elsewhere in Penguin.

We have reduced internet losses dramatically, down £44m from the same period last year and down £18m on the previous half. As you'll see FT.com losses actually rose in H1 '02 as we incurred one-off integration costs and development costs which we expensed.

We also remain confident about our two further commitments:

- FT.com will break even in Q4 this year.

- Learning Network will achieve breakeven in Q4 2003.

Our total internet losses will be below £60m in the full year.

Now moving to earnings.

Before I do, I need to cover the FRS19 impact.

Firstly, as you are aware, we are required to adopt this new tax accounting standard FRS19 for our half-year results and to restate 2001 for comparative purposes. You'll have seen this on our press release.

For Pearson the most material effect is to increase our effective tax rate – cash tax of course will be unaffected.

We will also recognise a deferred tax asset on our balance sheet, which I'll highlight later.

Our EPS of positive 0.5p compares to negative (1.5p) last year resulting both from the improvements we've made both in our operations and reduced finance charges.

We've also increased our dividend to 9.1p – a growth of 5%, well above the rate of inflation, reflecting our confidence in the second half.

Marjorie will give you more detailed guidance for the full year. The key message however is that we remain on track to achieve earnings growth in line with expectations.

There clearly is a $ exchange rate risk.

A rough rule of thumb you should apply is that a 5 cent change from the year-to-date range of £1/$1.45 will affect earnings by about 1p/share.

Our loss for the financial period is £207 million – compared to £118m in 2001 – down £90m. If we strip out the impact of a £120m tax provision release in 2001, our loss has in fact reduced by some £30m.

So let me take you through the make up:

Firstly, operating profit in 2001 includes the benefit of our TV business which we no longer have.

Secondly, as last year, you see the impact of goodwill, which we spread evenly across the year and this represents the bulk of that loss.

Thirdly, integration costs are £5m - significantly down on last year and in line with our expectations for £10m or less for the full year.

And finally, finance costs. These numbers include a one-time charge of £37 million which we signalled at year end, to close our interest rate swaps to come back in line with our Treasury guidelines. Our underlying finance charge was £50m and this is likely to be held or improved in the second half.

Let's turn now to the balance sheet and our use of capital – which is a real priority both for me and for Pearson.

Firstly, the balance sheet. Most importantly, we have strengthened it.

Our net debt is below £2bn – more than £900 million better than last year. This is largely due to the sale of our RTL stake. We got the cash in January of this year and this was used to pay down debt.

But, equally important, we have reined back on fixed asset investment and improved the efficiency of our working capital while continuing to increase investment in both Education and Penguin.

Here is where you'll see the deferred tax line at £280m; the impact on intangible assets is £68m.

Sticking with the balance sheet, these actions we took in the first half have improved our balance sheet ratios, in line with our commitment to a strong BBB+ rating.

Moving on to cash flow. Here we are beginning to see the impact of our working capital initiatives. Net seasonal build up has been cut by £43m at the half year.

Capital expenditure is reducing and being held in line with depreciation.

In 'other movements' the key adverse drivers are pensions (£40m) and the impact of restructuring provisions (£18m). On pensions, you'll remember that we advised you of a total funding need of £85 million in 2002, reducing to £60 - £65 million in future years assuming the same level of contributions. About £35-40 million of this is included in operating expenses.

The net result is that we improved our operating cash outflow by £(9)m and overall, free cash flow improved by £41m as we benefitted from reduced tax and finance outflows.

We've made a lot of references to working capital – and this why:

- Our net average working capital in Pearson is some £1.1bn. We look at average ratios because that demonstrates sustained improvement in cash management.

- If I break this down:
    - £80 m is the net of receivables and payables (receivables about £740m versus £660m in payables)
    - £ 460m is inventory/ stocks
    - £ 550m is pre-publication and author advances

- Clearly we need to approach these differently. Author advances and pre-publication costs are about investing for the future. It is critical that we continue to sign up the right authors and target the right education opportunities. The opportunity is to improve the efficiency of how we do that.

- On Inventory, receivables and payables, our task is to improve the velocity of our cash generation.

- If we look at where we use our working capital, we can see clearly that the FT is a cash business, operating on negative working capital.

- So all our working capital is in Education and Penguin – with 80-85% of that in Pearson Education.

Here's the position at the half-year.

We've invested a further £48 million in authors advances and pre-publication costs, yet our use of overall net working capital has improved by £17 million. This is the result of actions taken to improve our supply chain.

It is clearly early days, but we've already made significant progress in inventory reduction. As you know, managing working capital is not about a great silver bullet but about hundreds of actions right across the organisation:

- Getting suppliers to hold stock for us or provide on consignment
- Reducing quantities in our first print runs

- Improving forecasting and therefore reducing obsolescence
- Standardising everywhere – for example at Penguin Putnam we've standardised paper sizes from 60 to 9.

On receivables, we've improved our collections, focusing on larger customers, reducing process barriers – basically making it easier to pay Pearson.

And importantly, we're on track for our 5% reduction in average net working capital.

This is where we are:

- margins protected by cost management
- Balance sheet ratios improving
- Cash flow increasing

When I arrived at Pearson, the portfolio transformation was essentially complete. Pearson is today a coherent company with a very clear strategy.

So, my priorities are aligned with the changing focus at Pearson:

- delivering improved performance from a cohesive set of businesses, and

- Focusing on cash generation and return on capital.

Now let me hand over to Marjorie for the details of our business performance.

Marjorie Scardino

Thank you, Rona.

At the presentation of our 2001 results back in March (which seems like an age), we tried to do two things:

1. Firstly, to describe how we see each of our markets and the factors that will determine their growth for the next few years.

2. Secondly, given those markets, to outline the management agenda we have in each of our businesses.

Today I want to review both of those – our markets and what shape they're taking and our management agendas – and also to let you know more about our expectations for the full year.

As I said at the start, I expect this review to match our priorities for this year and show:

We are on track for an earnings rebound in 2002 and good performance in the form of best-in-class revenue growth and margins into the future. This will be due increasingly to our very complementary set of assets and our ability to use them to great advantage which is a huge priority around Pearson right now.

Let's look at how we're pursuing these priorities in each business.

Pearson's big challenge for the last year has been business advertising in the FT Group. The advertising downturn starting in April 2001 was the reason we didn't produce double-digit earnings last year.

It has continued to be bad this year, but we're in a slightly better position to wrestle with it than we were.

These are the FT Group results.

There are some bright spots:

1. The profit contribution from Recoletos is up. Its sports newspaper, Marca, is having a good year, and the costs of its international and online start up ventures are falling sharply.

2. Interactive Data is still delivering double-digit profit growth.

But the decline in total profits you see here reflects the fact that advertising sales – mainly in the FT – are lower by over 30% (some £40 million) than in the first half of last year.
(Of course, in the first quarter of last year ad sales were still growing for the FT, so that makes the comparison hard. But this is still a record downturn for us.)

This graph of the last 15 years illustrates the point. It only goes 15 years back because that's how long we've been collecting solid, reliable data.

Our circulation has stayed strong…

…but advertising is a different story. The green line is the ad volume, which is at at least a 15-year low; and the pink line is the revenue, which is more buoyant because our audience growth has allowed us to hold our ad rate.

As of June, our ad revenue is down 32% on the 1st half of last year, and 4% on the 2nd half.

Predicting the next six months requires supernatural powers which unfortunately I don't have. We did see sales pick up through the first 3 or 4 months of the year. But then the recovery stalled as corporate confidence fell along with corporate credibility.

The best I can say is that if current levels continue for the rest of this year, it could mean a volume decline of more than 20% on last year and would add up to about half the sales we had in 2000. That's not quite as big as the drop our closest competitor, the Wall St Journal, faces: their volumes fell 40% last year and are down a further 23% this year.

But it's big enough.

To help you understand where it's coming from – or not coming from – here you can see why business newspapers have been hardest hit:

The pie chart shows the four biggest categories of FT display advertising:

technology, finance, business-to-business are more than 70% of our ad revenue at the FT.

The numbers at the bottom measure total ad spending in international business titles like the WSJ, FT, The Economist, Fortune and Business Week in the first four months of the year.

For our three biggest categories, industry-wide volumes this year are down 35-40%.

Of course, we're working to broaden our range. Luxury goods are a target category. The success of our How To Spend It magazine through this entire downturn – where advertising revenues are up on last year – supports this strategy. In the US General Motors is advertising its new Cadillac in the FT. And the travel and hotel sectors are showing some promise.

But these categories can't make up for the scale of the downturn in the business and finance categories. We have to do more.

Therefore, this is the management agenda we showed you in March. And item number one on it is to manage our costs.

At the start of 2001 we started to make cuts and have continued to do so since then.

Costs in the newspaper alone in the first half of this year are some 15 percent lower than in the second half of 2000…

…even though the circulation is 5% higher as we've pursued the second item on our agenda:

Build the FT's reach and brand.

The ad recession won't last forever, so this is crucial to our future. We've been doing it successfully over the past five years and we know that we're going to have a business when the downturn ends.

Circulation was pretty much stagnant for a decade until 1997. It's doubled since then. Our readership worldwide is now about 1.5 million, and we're sustaining it with a smaller marketing spend than we had in 1996.

The growth of FT.com has been somewhat faster. From a standing start just three years ago, FT.com now has 2.8 million loyal monthly users. And that level is self-perpetuating – in fact, it requires almost no marketing money to carry on with that circulation.

That also gives us confidence about our third agenda item:

Ensuring that our investment in the FT's internet business pays off.

Rona told you about the progress we're making toward our breakeven targets.

We had already established advertising and content sales as viable revenue streams. Now our new subscription services are a meaningful part of the mix. Our new, two-tier service has already generated 16,000 new subscribers in 2 months, well ahead of our expectations.

So this gives us even more confidence FT.com will make its breakeven target by year-end.

The fourth item on our management agenda is to continue the strong growth of the FT Group's one non-cyclical business – Interactive Data.

This is a great business to be in at this point in the cycle:

1. 90% of its revenues come from subscriptions, and the contract renewal rates are over 95%.

2. It's part of the valuation, risk management and settlement process – so customers must have our services if they want to be in this business.

3. It values fixed income and illiquid securities. In this climate, it's a great advantage not to have to depend on the equity market.

4. Over the years, Interactive Data has also proven very effective at making good bolt-on acquisitions, and – true to form – its latest integration is going very well and coming in a little ahead of plan.

All these attributes, and the consistency and reliability of its performance, gives us good reason to count on IDC this year, too and gives us confidence for the future.

As you know, the FT is also our brand for business publishing and business education, and broadening its influence in these fields is the final item on our FT management agenda.

As an example, we've talked about the link between the FT and Prentice Hall on U.S. college campuses. This combination has, in its first few months:

1. Generated $1.5m in additional sales for the business & finance publishing group.

2. Signed up 1,000 new subscribers to the FT newspaper.

Small now, but just the beginning of what we believe is possible.

So this leads us to the outlook for the FT Group for the full year:

- We see no sign of an advertising recovery in our newspapers. We're assuming that advertising revenues in the 2nd half of this year will be no higher than in the 2nd half of last year.

- But we'll make more money because we'll have a lower cost base, not just at the FT but also in Les Echos, Recoletos and FT Deutschland.

- We'll also benefit from the fact that FT.com is set to break even at the end of this year and…

- that we expect Interactive Data to sustain double digit earnings growth

So at this stage we believe that, if advertising continues at current levels, the FT Group's profits will probably be down 10 – 15%. In addition, we expect losses from all FT enterprises to be less than £35m this year.

Now to Penguin…

Penguin accounts for almost 20% of Pearson, about the same size as the FT Group. It's consistently the best and most profitable performer in the consumer book publishing market, and it hasn't seen much in the way of effects from the economic cycle.

Its flat first half is better performance than planned given that its publishing schedule is geared toward the second half of the year, but it's been helped a lot by DK's progress.

Penguin's success in the first half has tracked its management agenda.

1. The first item was to increase its working capital efficiency. Rona has already talked about that, and it will continue to be a priority for everybody around here.

2. The next item – and the one that will deliver a real boost to Penguin's profits this year – is to restore Dorling Kindersley to profitability. We have made real progress toward that in the first half.

Here are the numbers for DK as a standalone business:

As you can see, sales were up and the business broke even in the first half – ahead of what we expected.

There's no one reason for the turnaround. It's due to a series of steps that we've talked about before:

Housecleaning; the Penguin sales team; bigger selling titles; the reinvigoration of DK's style.

What you can't yet see in these numbers is the impact that DK is adding to Pearson, Pearson Education in particular.

1) We now have a dedicated unit of DK designers working on 18 education projects – from the 2003 Texas social studies adoption to our first international reading program. They are all adding a lot of value to this work.

2) With the help of the breadth of Pearson, DK have just signed up the next 4 books of one of the best-selling business writers of all times – Tom Peters – because he wanted a truly innovative approach to business publishing.

We're more impressed than ever with the fit between DK and Pearson.

The third item on Penguin's agenda has been to keep making and selling the books that more people want to read, sector by sector, in a systematic approach to bestsellers.

Here's our line-up for the second half. We think this is one of the best publishing schedules we've ever had:

1. Adult fiction is led by our proven and reliable bestselling authors – the likes of Tom Clancy, Nora Roberts, Ken Follett, Marian Keyes and, the newest of the lot, Zadie Smith.

2. Adult non-fiction is a hot category right now too, and we have spectacular titles from established Penguin authors such as Patricia Cornwell (on her quest to identify the real "Jack the Ripper"), Clive Cussler, Jamie Oliver and Jeremy Paxman.

   And in this category we also have major celebrity biographies: from Ellen MacArthur, Gordon Banks, Roy Keane.

3. And third, we're building on DK's core – what it does best: illustrated reference – and the runaway success of Animal, the first example of DK's new, revitalised look. Animal's offspring are: the DK history of Flight, Judith Miller's Antiques Guide, Bill Wyman's History of the Rolling Stones. This is the sort of publishing that DK excels at: the most definitive, most beautiful books in their field.

The last item on Penguin's management agenda is to deliver back-office savings. That may sound decidedly unglamorous after contemplating the likes of Roy Keane, but it's very glitzy in profit terms.

Penguin and Pearson Education together are the world's largest book publisher and that gives us the potential for supply chain improvements that smaller competitors can't match.

We're furthest along in Australia and Canada, where we've now completely combined the two companies. That additional scale gives us $5 million of cost savings and is changing the way those businesses can operate, which will lead to more:

1. It allows us to afford better systems

2. It improves our service to customers by speeding up delivery times and making smaller orders economical

3. It gives us much more clout and negotiating power with both our suppliers and our retailers. In purchasing alone, we've made savings of some $35 million in the past 12 months

4. And it reduces administrative overheads.

In fact, this is working so well we're planning similar consolidations in a number of other markets, including the UK and the US.

All this combines to give us a fairly rosy outlook for Penguin.

Estimates are that the consumer publishing industry will grow in the 0-3% range this year. Once again, we expect to grow well ahead of the market.

Penguin's profits for the full year – which will be in double-digits – will be underpinned by DK's swing from a £7 million loss in 2001 to a 5% margin this year, and its steady improvement up to Penguin's margins.

Moving to education…

Pearson Education, our biggest business, is in four distinct, but related, markets which together make up more than 60% of Pearson, We're pleased with its first half although, as you know, it's a second half business, so a relatively small shift in phasing can affect the comparison.

And that's what we see this year in these numbers:

- As Rona said, in our US school business, last year states bought early. This year they have reverted to more normal phasing. So, although US school sales were down 8% through the end of June, we expect our full year revenues to match last year's record levels.

- Our US college business has the opposite situation – it's benefiting from phasing this year. Revenues are up 15% through the end of June, thanks mostly to an excellent sales performance by our college team. But we've also seen retailers buying more books earlier this year, for a variety of reasons.

- Our US professional operations are well ahead, too – up 17%. And international is stronger in school and college around the world (even in Latin America). But its technology publishing, a $120m business for us outside the US, is down 25%.

Let's start with some detail on how we're doing against our management agenda in education outside the US, which is about 14% of Pearson's total sales last year.

The first item on our international agenda was to restore profitability in Latin America. We expect to do that, which will be a $25m improvement on 2001.

We've:

1. Reduced costs

2. Written off bad debts, and

3. Tightened down on inventory and receivables.

At the same time, we've sustained good businesses in Brazil and Mexico, and preserved our ability to grow elsewhere in the region if and when the economy improves which is a good place to be in business.

The next agenda item was…

Teaching English around the world.

In the US, our ELT publishing business, which is reported in "International", is suffering a little as the number of international students at US colleges dips. But elsewhere the business of teaching English is roaring ahead and still a great business.

As I mentioned, our international school and college businesses are having a great year, especially in Asia:

In Japan, China, Thailand and Malaysia, we are expecting to be ahead of pretty aggressive plans, and we've opened up new markets in Korea and Taiwan this year, too.

We are also having a very strong year in Australia, and in Canada, our biggest single market outside the US.

And we are working to expand our testing and assessment business internationally.

I won't go into too much detail except to say that in the UK we've already signed a number of smaller contracts. And in Canada and Australia we have a few irons in the fire, too.

Achieving this agenda adds up to good, single-digit growth from our international operations this year. We're saying that even with the meltdown in technology publishing, we plan to be ahead of last year in international.

Next, this is our agenda for our US professional operations, about 11% of our total sales last year. This business serves several markets, whose varying fortunes reflect the times we live in:

1. It has some temporarily "challenged" markets ("challenged" being the current favourite term for "bad") – technology publishing and corporate training.

2. And it has some rapidly expanding markets: professional certification and government services being two of them.

Here's the management agenda for these businesses.

First, we are fulfilling our aim to protect the profitability of our technology publishing business at the time when revenue has been hit hard by the industry's downturn.

To protect our leading market position, we've cut costs in a number of ways and aimed our publishing mix toward the few growth areas we see in this market:

1. Design and graphics;

2. Open Source; and the

3. Corporate partnerships we have with the likes of Adobe, Cisco and Microsoft.

These actions will help us sustain good – 15% – margins.

Item number two is to make our corporate learning business profitable. Not easy in a market where corporations have cut back on training as quickly as they've cut advertising, and where we lack scale in some areas.

So we've pulled back to our basics, and we're benefitting from a cost base down almost 30% and from our focus on areas where there is current potential and we have market power:

1. This unit is working with our Government Solutions business to bid for new contracts to train Federal government employees. Since corporations aren't spending much money right now.

2. It is also making the most of our financial education business, since this is proving a good time to teach people how to read balance sheets and profit and loss statements. Our New York Institute of Finance business, which does this, is projecting growth on last year.

3. Finally, we are making alliances on the corporate learning side, because our business lacks the scale to go it alone. In the second half we'll begin to see some benefits from our venture with Accenture to make learning materials for this large consultancy's client base.

Professional certification, on the other hand, is a good growth market right now. Our sales are up 20% to the end of June, and we are taking share from the competition.

As of July 1st, we will be certifying all the clinical pathologists across the US. On October 1st we launch our online certification contract for National Council of State Boards of Nursing, which will add a few million dollars this year and about $15-18 million in 2003.

And, we now have 200 professional testing centers open for business across the US, and the online capabilities we have, we are confident of winning several more contracts over the next year.

Our Government solutions business has neatly taken care of the last item on our agenda here: it has doubled its revenues at the half year and should be up 80% or more at the full year.

A lot of this growth is coming from the roughly $100m contract we have this year with the US Transportation Security Agency. That contract is going well, and other government contracts are also.

The contract with the Navy and the INS, for instance, will really start to ramp up next year. And these contracts will continue to come in.

And the experience, access and profile we've gained through these recent contract wins mean new contract opportunities are opening up for us all the time.

Now let's talk about our US college business, which is the industry leader and made up 14% of our sales last year.

How are we doing against our agenda in this market?

The short answer is: "exceptionally well".

We are already the biggest and most profitable player in US college publishing (with a 30% plus market share and 20% plus margins) and we aim to use our size to keep on growing ahead of the market.

We did that in spectacular fashion in the first half of the year – we are up 15%, and the industry, without us, is up 6%.

Don't expect us to keep up that pace through the full year but do expect us to outperform the industry because…

1. We have a very strong publishing schedule;

2. We are some way ahead of the market in our use of technology, which is an integral part of all our major programs; has for several years been growing in popularity; we've talked about it a lot and is now really helping to drive both our adoption and sell-through rates.

Technology also helps us accomplish our third agenda item – publishing to order. We're twice as big as our nearest competitor in this fastest-growing part of the college market – custom publishing. Our sales grew by 35% last year to $60m. And we expect them to increase by a further 20% or more this year.

Finally, let's look at our US school operations, 23% of Pearson's sales. This business is about 40% of our total education sales but seems to attract much more interest than that and be susceptible to misunderstanding. So, here's a picture of it. Our business is divided into three parts:

1. *Basal and supplemental*: About two thirds of our $1.4 billion in US school sales come from basal and supplementary – school programs that meet local curriculum. This is the business most similar to Harcourt and McGraw Hill. We are stronger in basal than supplementary; and #2 in elementary, clear #1 in secondary.

Of the total market, half of the money is spent by adoption states and half by open territories. And 40% is spent on newly chosen books and 60% on books that were chosen in previous years. The rest of our US school revenues are split equally between testing and online businesses.

2. *Testing*: we are the largest testing company in the world. We specialise in administering and scoring large-scale, state-wide tests that measure how students are doing against standards. This market is around $400m and we have over 50% of it. It is set for growth, thanks to George W Bush.

3. *Software and learning*: this is software that helps schools run themselves, manage student data and performance or helps teachers teach and students learn. We lead in both markets, with a 40% plus share of each.

Of course, these revenue streams don't sit in silos. Our vision is that, over time, curriculum and assessment – textbook and computer – will become much more integrated. This is the only way forward for customised learning for every child. But, for now, this is a profile of our business and the market as a whole.

There are really three questions about the US school market right now:

- Is this a good business to be in? (I know some of you worry about the adoption demographic and economic cycles.)

- Will lower tax revenues hurt the market this year and in 2003?

- And how is Pearson doing? Are we gaining or losing share? How close are we to our vision of integrated learning?

So let's try and answer these questions…

Is this a good business to be in? Our answer is a resounding "Yes", and here's why:

1. As this chart shows, over the past 20 years spending on instructional materials has grown at an average of 8% per year, faster than school enrolments, GDP, and public spending on K-12 education as a whole. It has doubled – from $34 per student in 1981 to $69 per student today (in constant dollars).

2. In 1981, for every $1,000 of public money spent on public schools, $7.40 went to instructional materials. Today, it is $11.

In the last five years, while growth in total enrollments has slowed, spending on instructional materials has accelerated.

3. Materials spending is still a relatively small part of total education spending, but there is a real shift in priorities here because of the rise of the standards movement.

If politicians – and all of us – want to see students do better in reading and math, we all know they have to spend money closer to the problem, closer to the child – so on books and tests and teaching tools.

This priority is why, over a cycle, we expect the US school business to grow at the rate of 7-9%.

But what are the prospects for the next couple of years? Why aren't we projecting that kind of rate this year? The answer is that this is not a 'one year at a time' business. This is a cyclical business.

1. As we signalled a year ago, 2002 is a thinner year for adoptions. Less than $700m in new business against over $800m last year. Next year is better, although still not as good as 2001 was.

This is just a function of states' schedules for buying new subject materials. You might worry however whether this slower schedule is affected by the second question.

2. Will lower tax receipts hurt the market? State budgets are under pressure, of course. Total state revenues for the fiscal year ending June 30th were down 1.2%. Budget cuts, rainy day funds and tobacco settlement funds were all used to balance the books. States must have a balanced book at the end of the year.

   States expect revenues to fall again this year. But they're doing all they can to avoid cutting education. Only 17 of the 41 states making cuts in '02 looked to K-12 education for savings.

   And where education budgets are being cut, it is so far administrative and support services that are being trimmed, not instructional materials. Spending on items directly related to classroom instruction – curriculum, testing, tools for learning – are being protected. 40 states have now set budgets for the fiscal year that began on July 1st and, in those states, total K-12 spending is projected to GROW by 4.8% according to a report issued a couple of days ago by the National Council of State Legislators.

3. Overall education is the #1 priority.

Which leads us to the third, and crucial, question: How are we doing?

To answer that, let us look at progress against our agenda for the US school business.

The first item on our list of School Assignments is to grow profitably in school publishing, and we are doing just that this year.

For the first half, we're below last year because of the phasing of buying, but we expect revenues in 2002 to be level with last year. Our sales so far are very much in sync with that expectation:

1. We expect to grow at least in-line with the market in open territories, and that market produces more sales in the Second Half than in the First Half.

2. We expect to grow ahead of the market in supplementary publishing – helped by a very much stronger front list.

3. We will do well in adoptions. We've said that we wouldn't chase revenues at any price – and we haven't. We've been religious about that. So although there are fewer adoptions this year, we are only competing for around 65% of the adoption dollars, and we expect to take at least a 35% share of them. This chart outlines our progress.

We're also looking forward to 2003. There will be about 10% more adoption dollars to go for, and we'll be competing for a bigger share – over 80% - of that bigger pot.

Augmenting the opportunity will be:

1. New federal money will begin to come through: States will get $900m of new federal funding to support the "Reading First" initiative in the 02/03 fiscal year. At least two-thirds of this funding should go to textbooks, supplementary and online programs, some perhaps diverted into the regular curriculum sales. We'll compete for some of that, though we expect it will not begin to be meaningful until 2003.

2. New opportunities for our business: We have been innovators in the school business, and the addition of disciplines we haven't competed for before – the product of the increased "plant" investment Rona talked about – plus new online product and our beginning sales of our integrated learning products will boost our performance as well.

The next item on our school agenda is to extend our lead in assessment and testing.

1. To be clear – this is the market for large-scale state and federal testing contracts. It is currently valued at around $400m a year, and our share of it is over 50%.

2. We expect 2002 to be another good year with strong single-digit growth. The major contracts we've renewed in recent years help us - such as Texas, Florida and California – have gotten larger. (California is $160m over 3 years; we share it with our partner, ETS, but we get more than 70% of it.)

3. We also continue to lead the market in online testing. We have the contracts in Georgia, Maryland and Virginia; we are about to conduct pilots in Florida and Texas.

4. And we are ready and able to meet the testing demand created by the new Federal legislation that could double the market over the next five years, with the growth really kicking in 2004. We are confident of our ability at least to sustain our current market share in that period.

We are also pleased with the progress we are making against our two other objectives:

1. One is early learning. There's a lot of new funding to support programs for 4-6 year old children, and we want to be the leader in this field. Our business did $60m in revenues last year, and it should be capable of 15%-20% annual growth over the next five years if new federal funds come through.

2. The other area we lead in is online learning.

   a. NCS4School is set for its full roll-out this fall and is already installed in several sites. It's a year later than planned, but we think it has been worth the wait. That extra year has allowed us to develop a product that is closely aligned to the demands on school districts created by President Bush's "No Child Left Behind" legislation, and we're upbeat about its prospects.

   b. Our other products – Waterford Early Reading and Math, Success Maker, Knowledge Box, and Family Education Network – are also all innovative and part of our integrated learning solutions.

Before we leave education, let me say a word about NCS. As you know, NCS is now an integral part of our education business, but I know you like to track it on a standalone basis, so here are the numbers.

At the half year, stripping out the benefit of two small acquisitions made early last year, revenues are up 10% on an underlying basis and profits are up 13%.

As a whole, NCS is running ahead of its budget and aiming for $1 billion in sales this year.

As importantly, we see that these businesses can sustain around 15% annual top line growth over the next three years, in line with our expectations when we acquired NCS two years ago today. So this is an anniversary we're celebrating.

So this is our outlook for education for the full year:

1. We expect our US school business to be level with last.

2. We expect high single-digit growth from our US college business and very good double-digit growth from our professional operations.

3. And we expect International to be ahead of last year.

That should deliver revenue growth for all our education operations in the 3-6% range.

The strongest revenue growth is coming from our lower margin businesses, such as government solutions and testing and assessment, but we will also benefit from a lower cost base across Pearson Education and lower internet losses.

And this is the outlook for Pearson:

Taking all our markets and businesses into consideration, our outlook for the full year for Pearson is unchanged from what we gave you in March.

Our earnings will return to double-digit growth this year, and our cash performance will improve. That progress will be thanks to strong competitive performances from all our businesses, even the FT, which is bloody, but unbowed.

Just as we are.

Thank you.