Pearson
Preliminary Results 2003

Marjorie Scardino
Chief Executive Officer

Good morning everybody. Welcome to the presentation of Pearson's 2003 Results. There are at least two people who have wives in labour today, and I'm really anxious about that, so, if anybody would like to come and sit on the front row it is okay. Thank you for going to the trouble to come, we always appreciate you taking time to be here.

We have three main areas we want to cover today, first, the main event 2003. Our messages are in 2003 we increased our earnings, we continued to reduce our costs and improve our operational efficiency and gain market share in our largest businesses at the same time that we were investing heavily in our products and services.

In 2004, we expect to improve our financial and competitive performance once again in underlying terms and, at the same time we expect to keep on investing for 2005 when we will make very strong gains on all of our financial goals.

Here are the financial highlights of 2003, you will already have seen them in the press release probably. Though operating profits were flat, our operating margins were up from 11.4% to 12.1%. Our cash is behind the previous year, but that is because of the TSA otherwise we would be well ahead. Our adjusted earnings per share are up 6% or 11% in constant currency. Our return on invested capital is up to 6.3% and we have increased our dividend above the level of inflation for the 12th straight year.

This is a good performance we think in tough markets and, it reflects not only the competitive strength and the resilience of our company, but our confidence in the future.
Rona is going to give you the details of 2003 and then I'll come back and talk a little bit about that future.

Rona Fairhead
Chief Financial Officer

Thank you Marjorie. You will all have seen our results by now. So, I just wanted to outline some of the key factors and to give you a little more colour behind the numbers.

We began 2003 with three priorities, to improve earnings, to improve cash and to improve returns.

We increased earnings per share by 6% or 11% at constant exchange rate, despite the continuing advertising and technology recession. Margins improved in each one of our three businesses, because of a better sales mix and because our operating efficiency drives started to bear fruit.
We made good progress on cash management as we'll demonstrate and, we would have been ahead of last year, but for some timing issues, which I'll cover later.

Finally, we increased our ROIC from 6% to 6.3%. This uplift included an exchange rate benefit, but it remains our goal to rise to and then exceed our cost of capital.
Obviously the dollar exchange rates had a material impact on our reported numbers. So, we have given you our growth rates on a constant currency basis, alongside our normal underlying measure for your analysis.

As I review performance though, I am going to talk to you underlying growth rates for sales and operating profit that is stripping out both the effect of the exchange rate, as well as the effect of any portfolio changes.

So, if we start with our School business, which represents now about 30% of Pearson's sales. Sales grew 1% and operating profit was up 13%. The US accounts for more than two thirds of this business and here, sales were up 2% and margins improved.

Our basal publishing business grew 4% in a market which grew 1%, and we ended the year as a market leader in both new adoptions and the basal market as a whole.

Supplemental and software sales were down. These were affected by state budget pressures and because of the equity from some unprofitable areas. Supplemental margins were down, but the software business moved from small losses to a modest profit.

Assessment and testing had a relatively flat year in both sales and profit, but we ended the year with some $300m of new contracts and are in pole position for the NCLB mandatory testing.
Outside the US our reported numbers include the addition of Edexcel, which we purchased in May and which performed well in 2003. Edexcel apart, international sales grew share, rising 7% throughout thanks to strong performance in Hong Kong, South Africa the UK and the Middle East.
Overall margins in Schools improved to 10.8% as we benefited from this top line flow through as well as our business integration and operating improvements.

Higher Education had its fifth successive year of above market growth. US College grew 6% in a market up just 3%. Outside the US our College imprint posted similar levels of strong growth. We continue to benefit from our technology products, the strength of our imprints and our strength in custom publishing.

State budget pressures did slow growth a little, but this was more than offset by the fundamental demand for college education. Profit was up 11% as margins rose in both the US and internationally.

Our Professional business ended the year with sales down 30%. Obviously TSA sales of some £250m in 2002 and the related profits were not repeated in 2003 as this was a one-off contract. In addition, and as we advised in our December update, we took a conservative approach to all close-out costs and transition costs and expensed these in full. These increased costs by some £50m. That apart, both Government Solutions and Professional Testing grew by some 40% and 50% respectively. Furthermore we secured a series of new multi-year contracts, worth over $800m, which Marjorie will touch on later.

Our Technology Publishing business declined by some 12%, though again we extended our market leadership and maintained margins.

Turning now to Penguin, which represents just over 20% of our sales. Penguin had another record year of sales, with an exceptionally strong front list performance in the US and in Australia. In the UK we advanced because of the classics re-launch, the Penguin classics relaunch and the BBC's Big Read.

Margins were a shade lower at DK as the weak US back list led to some retailer de-stocking and with its costs mainly in the UK, it was more affected by the weaker dollar. However, margins overall at the Penguin Group rose as we benefited from the front list sell through and the back office integration with Pearson Education.

Sales at the FT Group were down 2%, but profits grew 8%. All our business newspapers felt the continued advertising recession. Advertising revenues declined further in the build-up to, as well as during the Iraq War, but we exited the year with the first, but still very erratic signs of recovery, particularly in such as areas as recruitment, online and M&A activity, two of which tend to be leading indicators.

Recoletos overcame the business advertising decline through strong growth in Marca and other consumer titles, but profits were down as we continued to invest.

Across our publishing business, which includes of course, the JV's and Associates, operating profit fell some £5m. We continued to invest in our brands to position them for a recovery, and sought to off-set these investments through cost savings.

If we just look at the FT, for example, the combination of the advertising fall in 2003 and our product investment, would have reduced profits by over £30m. We mitigated that profit decline to some £9m because of our focus on costs.
Looking forward we will continue to invest in the FT, but we still expect around a £20m improvement at the FT alone, without an advertising recovery.

Interactive Data rose 2% in a falling market and remains the main contributor to profits. It continued its upward trajectory and posted profits up 18% underlying or 24% at constant exchange rate. Margins rose slightly as we benefited from some early savings of our recent acquisitions.
If we move further down the P&L, you will see that we continued to make improvements on our finance and our tax charges. Interest charges were better as a result of good through the year cash management, lower rates and, of course, the dollar exchange rate.

Our tax rate was better than expected at 31.2%. We have worked hard on our tax planning and we benefited from a combination of this, some close-out credit from prior years and a significantly weaker year-end dollar. Together these results delivered us the 6% uplift in our EPS.

As you know our guidance on sensitivity is at a $0.05 change in full-year average rate reduces or decreases EPS by about 1p. This held true in 2003 and is the impact we expect for 2004.

In terms of operating profit, the same movement affects Pearson Education by some £8m to £10m and Penguin by some £2m to £3m.

Here we have also shown the impact of the average and the year-end rates on ROIC. We were helped by the greater year-end movement compared to the movement in average rates.

On a statutory basis our operating profit is up £83m, we had lower goodwill charges and with no major acquisition since 2000, no integration charges. Restructuring costs in our ongoing businesses are absorbed within our operating profits. Total profit was up £166m because of lower finance charges and, this resulted in an EPS of 6.9p versus a loss of 13.9p last year.

Turning to cash, which as you know has been a focus of ours. We generated £192m of total free cash flow in 2003 and would have been significantly ahead of last year, had we received the TSA payment. Much has been achieved in cash terms in 2003, our cash flows vastly improved by lower non-operating outflows, which were down from £90m in 2002 to £18m in 2003. We had no non-operating finance charges and significantly reduced integration cash outflows. Our operating finance and cash tax payments were also down by £40m.

Looking at the operating cash flow, we kept capital expenditure below depreciation. So, there are two main factors for the 65% cash conversion. Those were, firstly, the other movements, the £45m, and the vast bulk of that is the exchange rate and the effect of the change from the average rate on operating profits to the year-end rate and obviously the working capital outflow of £136m.

This working capital outflow was the result of three factors that we have been signalling all year. Firstly, the increased investment in author’s advances and school programs ahead of the big years in 2005 and beyond.

Secondly the TSA, although clearly the receivable was unchanged in 2002 and 2003, we made supplier payments of some £50m.

Finally, sales phasing, Penguin’s Q4 front list shifted over $80m of cash collections out of 2003 and into 2004, which of course was great for sales, but not so great for the year-end cash position. We also had a very strong end in our Higher Education business. These changes were offset in part by some improved DSO’s at the year-end, as well as some inventory improvements.

A brief update on Penguin cash, the January cash collections were $50m ahead of 2003. Given those timing factors which affected us in 2003 are not excepted to recur, we expect to be ahead on cash in 2004 and, we expect to receive the TSA payment in full, even though timing is uncertain. As you know, for operating purposes we drive cash on an average rolling basis and this removes any timing effects.

Including the TSA our average working capital ratio rose as we indicated. However, stripping this out, we again improved our annual average working capital to sales, underlying performance was good, particularly in inventory management. The overall improvement was encouraging, because as you'll see we continued to invest in author advances and in our pre-publications for future growth.

The net result of this was that our debt fell to just below £1.4bn, with 86% of these in US dollars. We maintained the strength of our balance sheet through the year. Our key ratios were stable or better. Net debt to EBITDA was unchanged at 2.3% and interest cover increased from 5.2 times to 6.1 times.

Finally, we improved our return on invested capital from 6% to 6.3%, or from 6% to 6.1% at constant currency. In 2004 we expect to be up a little at constant exchange rates and are very confident of a significant uplift from next year.

Going forward we have four clear financial priorities. We will continue to find ways to do business more efficiently, we will continue to manage cash tightly, we will drive the business towards delivering a return above the cost of capital, and we will deliver underlying progress on earnings, even as we set the foundations for significant growth in 2005 and beyond.

Marjorie Scardino

Chief Executive Officer

Thank you, Rona.
Our outlook for the years ahead is positive. So I'd like to spend a few minutes now giving you some concrete reasons why we have that perspective, and talking a bit about our markets and about why we think we will succeed in those markets.

Our advantage in Pearson really starts with the fact that that our main businesses are all leaders in their markets. Those leading positions are strengthened by the fact that we are now one company, not a collection of companies, and that cohesion really has value for us.

We are more productive and innovative because our businesses share processes, and costs and technology and assets, and a particular culture that facilities their collaboration all the time.
But, we do know that to stay in the lead, we have to continue to make our operations leaner, and we have to continue to make our products stronger, so we've been doing exactly that.

First, we've been working on how we run things, steadily reducing costs, making better use of working capital, as Rhona said, assessing our investments with a lot more rigor and higher hurdle rates, generally improving our processes and our disciplines and making our operations more streamlined and more efficient.

At the same time, we've been investing in our products, making them more relevant and innovative, more competitive on value and generally making them stronger. As those investments and efficiency in products have been successful, they then help to make our leadership positions in the market ever stronger.

That virtuous circle is what our aim is. It's to continue to follow that particular path.
So let me outline some of the results of what we've been doing to make our operations leaner:-
We've been losing weight through an efficiency program across our whole company. It doesn't have a catchy name, because we've been trying to make this more of an everyday thing, not a special affair. Over the past three years, however, this program has really helped us to reduce costs all over the company. Let me give you some examples.

Of course, we have first taken most of the costs out we could out of our most cyclical or challenging businesses - £100m out of the FT, £40m out of DK, £50m out of Technology Publishing, £25m out of our Digital Learning business. Beyond that, we've been working on the many, many operational changes that just make us better all the time. For instance, we've been taking out layers and combining units. We've integrated the FT's commercial unit with organizations around Europe and the UK. We've merged some of our international education businesses. We've consolidated in regions.

Many of you will remember that in 2002 we consolidated our book publishing businesses in Canada, Australia and in India. Last year we saw the first results of that. The operating profits for each of those businesses were up 12%, 17% and 22% respectively. So we think that's been a real success.

Our back offices have been partly integrated in the UK for several years. This year, in fact, next week, we add distribution and warehousing as we open up in the Midlands, and we're also beginning to benefit from some US consolidation of our central functions. This integration, as we told you, I think, before, is on track to deliver £20m of annual cost savings from next year, and we do see more to go for on that.

We've also gotten leaner by rationalizing things, by using our scale to our advantage. We've improved our paper printing and binding costs. We've reduced our stable of suppliers. We've increased our amount of inter-managed inventory. We've cut production costs. We've also been sharing assets.

We're very much more geared now - because we're more collaborative and cohesive - more geared to extracting value from the assets that we can share all across Pearson. Our digital content library, for instance, can be used by any part of the company, and we're steadily moving towards similar systems all around the group, and shared technology – things like the know-how of DK designs, which really enliven our school programs now is shared freely around the company.

Of course, as Rhona has talked to you about, we are working capital harder. Almost all our capital is employed in our book businesses, and that's where we've been looking for efficiency. Just a few examples of that – in the past three years we've lowered inventory in Education by a third. In Penguin UK we're turning inventory twice as fast.

The thousand titles in our Automatic Inventory Replenishment Program now turn four times faster than they did before. Our Print on Demand program covers 3,000 backlist titles that last year generated about $15m worth of sales for books we wouldn't otherwise have sold.

In Penguin, we're also saving by standardizing book sizes. We're now down to sixteen sizes in each of hardback and paperback from about 100. And we're making our pre-publication cost spend more efficient while we're investing more. We've had the time it takes, for instance, to make some of those big landmark books at DK's and that lowers the cost of creating those books by about 25%.

Those are just some of the results. We could really go on, we've had a lot of projects, but this is the result of the saving those costs. They are accompanied by very steady margin improvement in every unit. Of course, these improvements also reflect the efficacy and efficiency of our sales and marketing, but it does take more than one ingredient to make a strong enterprise.

So, in addition to efficient operations we will succeed because of the strength of our products and services. Over the past three years, we've invested almost £2b to build a product that builds market share for us. This year, that investment will be the highest it's ever been, and about $700m. Our investment discipline requires that each product be earned back significantly more than our cost of capital over its life, so those investments are scrutinized financially as well as strategically, but they will be crucial to our future.

Let me give you some examples of the kind of investments we're making. In Consumer Books, we've grown ahead of the market consistently and profitably thanks to investment in several areas. The first is investing in our ability to find the authors who are able to write bestselling books on a regular basis, a continual basis. That takes three forms, first of all, our bestselling authors.
We are making more multi-year and multi-market deals with them. These are the big bestselling authors who provide very predictable revenue streams. So, our top ten authors in Penguin now are under contract to us for an average of about four years. This gives us publishing security, and it gives us pricing security.

At the same time, we look for first time authors who generate the highest margins, by the way, and who can keep on selling books year after year, as well as they keep on writing new books. A good example is Sue Monk Kidd, whose book you see there, "The Secret Life of Bees." She sold over 2m copies of that book, than on the New York Times bestseller list, for about 56 weeks. That's the sort of author we like to see.

We're also creating new imprints. You remember that we introduced Ann Godoff into our Penguin US company last year. Her new imprint, Penguin Press, has now signed 100 new authors, and that gives us a real leg up. And we've also started new lists in Politics and in Business, we think those are going to be real winners.

Our second advantage is that we're able to grow our own – that we're able to create unique content in-house. This costs less, it generates steady sales over years, and it gives us material that we can use across many formats. A good example is what you see here – the DK series that started with Animal. It sold 200,000 copies in its copyright year, and it's now sold more than five times that, and we're using its content in 23 languages and across succeeding formats in four books in that series.

Finally, in Penguin, we are looking at channel innovations. We're going to invest in these this year. This year, we're launching an e-commerce site, we're setting up a small division to turn Penguin non-fiction into interesting television, and we're dipping a toe in the water of direct sales in the US.

In Education, we've been using some of that close to £2bn to invest in strong products to build our market positions in the US school business. Our elementary social studies programs swept the market in 2003, it gained a share of about 60%. In elementary reading and secondary literature we've taken our share from less than 10% to somewhere in the mid 30% range.

This year, when some 50% of the total new adoption opportunity is in Maths, we expect to maintain our number one position in K12.

You can see the strength of our record here from this slide, and looking ahead, we can see that we also have strong positions in all the subjects that are going to matter. Through 2006, more than half of the adoption opportunities are in subjects where we lead the market.

In addition to peer publishing, we think we can widen our lead in the US school business because we have had a vision of how to make sure no child is left behind longer than any of our competitors. We now have all the parts to accomplish that vision, and we are the only educational player who does it. We are already selling products and services that meet that vision.

Just to remind you, our personalized learning aim has been to use technology to connect books, and the teacher's classroom works, and assessment to see if the child has learned, and data about him to help the teacher figure out why he might not have learned, and tools to deliver practice, or re-teaching to help him when he really hasn't learned. That is the revolution in education. We've been chasing it for a while, we've been investing in it. Our major costs are behind us, and we are profiting from it, with leading products that are already out in the classroom.

Just a few examples of this – our online assessment and intervention is embedded in our basal maths programme for this year's Florida, North Carolina, Alabama and Oklahoma adoptions. We have the lead in online state testing. We have a number of state testing contract, and they are typified by our contract with Virginia, which tests right now 95,000 students online. That will ramp up by a factor of about three or four this year, and it is, for the first time, crucially linked, to a data warehouse that we manage. They are the first state to try that, and we are very excited about the innovation and testing reporting it's going to mean.

We also have the lead in the newly mandatory collecting and reporting of student data. We already do it in 30,000 American schools, and we are the market leader.

In Concert, our integrated schools, student information and teaching system, it brings it all together. It's already in fifteen school districts, it's fully linked to instruction, and it's moving along very well.

That same move towards personalized learning has been going on in our Higher Ed business for a long time as well. We are the lead now in the college market in custom publishing, where we make textbooks to order for individual professors. Last year that business was up 35% again. It's now over 100m, and we're moving the concept into the school market too.

Online instruction, which puts our learning platform and content at the centre of the teaching process, is the second part of our college advantage. Last year, 1m college students used our paid-for online materials, bought in a bundle or bought singly. That was an increase of about 30% on the previous year, and we now reach more than 5% of the total US college audience with that program. This will accelerate as we roll out into many more subjects.

We also have embedded assessment. We do this in school, and we also do it in colleges and online service. Testing and figuring out what students have learned, and what they haven't learned is fundamental to the learning process, no matter what your age, and we are the only publisher to do that.

We've grown faster in the US higher education for five straight years than any of our competitors. Great publishing is certainly fundamental to that. Last year, we published 1,600 new first edition books. We've invested in the many disciplines where we lead the market, and we continue to expand aggressively into new disciplines like Allied Help and Languages, things where we don't lead the market, and we think we can get a stronger position.

On top of great publishing, this kind of investment in new technology and services is really what continues to make our out performance possible and very sustainable.
That technology lead is also at the heart of our approach to the market beyond college, the professional market. Our professional testing and certification business was up 50% in sales last year, as Rona said. That was helped by the contracts you see as depicted on this slide full of logos. In fact, we won $600m of new business last year, business that tests UK drivers for the DSA, potential business school students with the GMAT, securities professionals for NASD certification, health professionals, just to name a few.

We see a good deal of growth, and a lot of margin potential in this business for next year. This business gives us a worldwide network of about 3,800 testing centres which we can use for other contracts, and possibly more importantly, it gives us very predictable revenues and profits from 2005.

In fact, that point – contracted-for revenue with predicted profits in revenue - is another factor that really underpins our confidence in our future. Professional testing is just one of our businesses that has that kind of solid contracted-for base. Another one that you know pretty well is IDC, Interactive Data, where our advantage comes from annually contracted revenues of about 90%, with a renewal rate of about 90% or 95%.

What creates that base, of course, and that steady step up of their growth, is that we have products that combine the very best in data and analysis, and we do things that other firms find very tough to do, in areas that others just don't cover. IDC's major source of growth still is their ability to move quickly, to price new illiquid securities and other instruments.

They are also very innovative – for instance, their Fair Value Information Services that allows pricing 24 hours a day was launched only last year. I think we talked about it first here, and it is now being used by 35 of the world's largest mutual funds.

In addition, the move into real-time pricing boosted by the acquisition of Comstock in the hyper-feed customer base, expands their selection of services. IDC is now creating and managing real-time financial data intranets and extranets for the employees and the customers of two of the world's largest financial institutions, for example.

All these kinds of products and investments have enabled Interactive Data to have four consecutive years of positive inflection points, while just about every other financial data business has been inflecting negatively. That's pretty good, moving from £40m five years ago to £150m today. At this point in the cycle, we are very, very delighted that it has been able to do that because this has been the toughest of all times for our business newspapers, which make up the rest of the FT Group.

What's kept us going through this time, though, is that we really understand that our newspapers are premium brands and they require steadfast commitment through the peaks and the troughs of the cycle to keep them strong. That's why we've kept on investing in them, and we're glad we have. The results are encouraging so far. Les Echos has increased its circulation 4% since its re-launch, while its French peers have declined 6%.
Expansión in Spain has strengthened its readership market share to almost 60%, and FT Deutschland's circulation is up 10%, and its advertising revenues are up 25% in the declining market in Germany.

Of course, our biggest challenge, and our biggest newspaper investments have been at the FT, where we've been working on turning what was a UK Europe newspaper into a global business information brand. With the growth in the United States, and the launch of the Asian edition, and the increase of FT.com subscriptions, we are making headway. We now have four international editions alongside FT, reporting throughout the day, sharing a single cost base.

Although our paper circulation is down, our online circulation is growing in the UK, so we have maintained our paid-for readership for the FT and FT.com together worldwide, at around a historic high of 500,000.

We've also produced healthy increases in circulation yields and advertising yields here in the UK, reflecting very well on our continued ability to reach those audiences that are elusive for all the other newspapers.

So, those are the areas we're concentrating on for our future, leaner operations, stronger products and keeping our market position solid. We have made a lot of progress, but what does all this really mean for 2004?

Let's think about 2004 first. As you know, the slow adoption calendar, the uncertainty of an advertising rebound makes 2004 a challenge, but we think we've got some very good ground for optimism.

First, business advertising remains erratic, but the rate of advertising revenue decline in the FT, which was 15% last year, is 4% this year so far. Forward bookings are a little bit ahead, so we may be past the worst of it. But it's still too early to call a recovery and so we have budgeted on the basis that our progress has to depend on cost efficiency, rather than revenue growth.

On that basis, we expect the FT Group's profits to be strongly ahead, as Rona said, thanks to the £20m of costs savings we had this year, and another good year at Interactive Data.

In Consumer Books, we expect to have another year of good underlying revenue, though their margins may be hit a bit, because we'll continue investing in our publishing and investing in those new channels that I talked about.

In Education, we expect another year of growth above the market. College should be somewhere around 4% to 6% and we expect our Professional business to grow again too.

In School, the US recovery is replenishing state budgets, the deficits are gone for most states, legislators are now proposing across the country an average of about 3% as an increase in the education budget. It's too late to benefit this financial year, of course, but it will flow through into next year.

As for the weak adoption list, I'd like to talk a little bit about that, because it's very, very important to understanding our outlook.

If you look here, you see there was a relatively flat market in new adoptions and open territories in 2003, with better growth in other categories of School business then. For 2004, we estimate that the new adoption opportunities will be about 30% lower, or at some $500m. So if the other segments of the market grow at rates similar to the rate they grew in 2003, we expect that the total basal publishing market will be down somewhere in the mid single digits.

That will push our publishing margins down a point or two, since we will be investing, but progress in our digital and our testing business will buoy the rest of our School division so that our performance will remain broadly flat.

Let me end with a few words about the outlook for 2005. A lot of you have asked us how we see this year, and it's pretty early, but I'd like to give you our thinking, because the longer view does have a bearing on how we've approached 2003 and 2004.

Just to put it in context – we don't see 2005 as a one-off, we see it as a return to a more normal operating environment after the very difficult period we've just been through.

First, the adoption cycle in 2005 is again a very important ingredient in the potential, as you know. On our estimates, and these really can only be estimates at this point, the new adoption opportunities will be somewhere around $900m in 2005, depending on what your definition is, versus $500m in 2004. To demonstrate the effect, we assumed low single-digit growth in backlist sales in open territories in supplemental publishing, and on that basis, you can see why we would expect our School publishing business to grow in double digits next year, and profits to grow faster than revenues as we at least regain the margin that we might give up this year as we invest.

Our second reason for confidence about 2005 is that so much of our business is now contract based. If you look at these three businesses here, Government Solutions, Professional Testing and School Testing, in any given year, 75% of the revenue from those three businesses is already under contract when we start the year, so our challenge is to increase new business to fuel their future years' growth.

We really have been doing that, and the new business you see on this chart will kick in next year. In Government Solutions will benefit from the major contracts we won last year, with the US Department of Education, and the INS, as well as new work with the Department of Health.

In Professional Testing, in 2005 we gain full year revenue from all those contracts I outlined earlier, the $600m of contract wins. And in School Testing, No Child Left Behind contract requirements really start to kick in during the 2005/2006 school year. We won $300m of new business this year, mostly from states preparing to meet those testing requirements, and our pipeline of new bid opportunities is strong, so we expect our testing business will chalk up double digit revenues in 2005.

Our third reason for confidence, though the timing does remain uncertain, is the work we've been doing to strengthen our cyclical businesses for recovery. Here, our four main cyclical businesses that have been most hit by the economic downturn, the FT and our business papers, technology publishing and school software business, we have made significant reductions, as I mentioned, in the cost base of each one of those.

In the newspapers, the rate of decline in each of them is diminishing. I mentioned the FT's position, but the other newspapers see somewhat the same thing. There is a little bit of improvement in the forward bookings, and the slowing of that decline.

In technology publishing, the sales decline in the US has slowed to the mid single digits, so the rest of the world is still lagging behind.

The school digital business is projecting growth, thanks to requirement benefits from NCLB, and thanks to collaboration around Pearson.

The point is that in all these businesses over the past three years, we've reduced their combined cost base by about £165m, so we expect a drop-through of the revenue improvement, as you see here, to run from around 50% to around 80%, which is quite a bit of leverage when the cycle ends.

So, I hope I've given you some concrete reasons to share our confidence about our prospects going forward. We demonstrated in 2003 that we'd made significant efficiency and market share gains, and improved margins, and that we do know how to make profits in tough times. We expect further underlying financial progress in 2004, and we see potential for vigorous growth in 2005.

Our businesses have been through some of the toughest markets that anybody can remember, but they have all emerged leaner, and they have all emerged stronger.

One of the most important elements of our culture in Pearson is that we have goals that are very closely connected to the products and services that we make, whether we're giving businesses high quality market intelligence, or we're teaching children Math, or we're helping entertain someone with a book. But there is one focus that is just as crucial to us in our culture, and that's our very strong commitment to financial goals, because we do know that financial goals are the goals that make all our others possible. So we are going to keep striving to meet those goals this year, and in the years ahead. You can count on that.

Thank you very much. Rona and I will be happy to answer some questions, and we're going to be joined on the stage by all the mental firepower we could dredge up! We've got John Latinson from Penguin, we've got Olivier Fleurot from the FT, we have Steve Dowling who runs all of our School businesses, including Testing, we've got Will Ethridge who runs our Higher Ed business and our International business, so they're all going to come up here.

While they are coming up, some of you may be thinking about Peter Jovanovich who is not here today. A number of you have written very nice and encouraging notes to him and to us, for which we thank you and he thanks you. He is working very hard on getting well, because his brain is not the part of his body that's sick, so he has been really very much involved in helping us think through some strategic issues, for which we're very thankful. Will and Steve run just about all of the company. So I can't think of any other issues that we can't handle here.

Question and Answer Session

Marjorie Scardino

So, who wants to start the first question? Colin?

Unidentified Participant – [Colin Tennant, Lehman Brothers]

Thanks, I have a couple of questions on numbers actually. One is simply in the Schools division, there is quite a big difference between the constant currency change and the underlying. You mentioned Edexcel, but I wondered what else is in there? I think it was 1% for underlying and 8% change in constant currency, so quite a big number there.
Also, on the creditors in the cash flow, you mentioned again there the TSA contract as a factor there, but there is quite a big swing in the cash flow and creditors, about £130m or so. I wonder if you could just break out for us how much of that is TSA and how much is other things?

Marjorie Scardino

So, School underlying change and cash flow change.

Rona Fairhead

I missed the one, the TSA?

Unidentified Participant

Within that creditor's swing in the cash flow, there is quite a big swing overall, I wondered how much of that is...?

Rona Fairhead

There is no swing in the creditors. In terms of the receivable it was £151m at the end of 2002 and it remains at £151m at the end of 2003.

Unidentified Participant

So, why have creditors moved so much then in the cash flow?

Rona Fairhead

That was where the payable from that big Q4 sales of Penguin and in our Higher Education. That was the cash that I said that the receivables were up, but the cash would not be collected until Q1 2004, which is now starting to come in.
In terms of the underlying – does that answer your question?

Unidentified Participant

I think so. So, basically it is within Penguin and Education?

Rona Fairhead

It is that Penguin Q4 sales phasing, which as I said shifted $80m of sales and the money was collected or will be collected in Q1. And, as I said, $50m has already come in ahead of the prior year.
Higher Education had a very strong Q4, so those are the two main reasons. The TSA obviously was unchanged as it remained unpaid, but we expect to get it in full.
In terms of the underlying, I am pretty sure it is just the effect of Ed Excel and the dollar exchange rate, and that's how the numbers work. There is [not actually a big swing].

Marjorie Scardino

Is that clear with everybody? Because the man behind you was shaking his head, pass your microphone to him.

Unidentified Participant

Just to clarify, that would be a debtor, wouldn't it be related to Penguin not a creditor. I think he was asking about the creditor outflow.

Rona Fairhead

Yes, that was what I said, we were going through the working capital, we obviously had the receivable that we kept and in that £151m it was made up of revenues that we booked and ODCs or pass-through costs. So, that was the vendor payments that I referred to in the pass through, £50m which we paid out those vendors even though we haven't received the money from the TSA.

Unidentified Participant

Okay, so it's not so much a Penguin issue as it is a TSA.

Rona Fairhead

Sorry, I thought you wanted the receivables sorry.

Unidentified Participant

No, no I was asking about the creditors, I think that's what he was asking as well.

Rona Fairhead

I was distracted by the underlying.

Marjorie Scardino

Okay, next? Okay, since you may have to go. This is the person whose wife is in labour, I want you to just look at him.

Unidentified Participant

Reading First, just a few questions on that. How big is the opportunity this year, and how are you doing and what has happened so far? Is the Reading First money included in the -5% you got in for the market, or have you excluded it because you just don't know when it's coming and how big it is going to be?

Steve Dowling, Executive Vice President, Pearson Education

The Reading First money is finally getting into the market. It has taken a while – it is a competitive bid process first, it is unlike some of the other fundings that have come through with title one. School districts have to compete, they have to file an application to state it is competitive and then the money is awarded. So, it has finally got into the market.

A couple of ways the money has been spent. A lot of the money has been spent on teacher training and on hiring tutors for example, literacy tutors. You go to a place like Los Angeles they have used the money to hire literacy tutors to actually help improve the quality of the instruction. There is also money being put into administrative costs, so some of the money is going into administrative costs. Then some of the money has gone into materials, has come into the materials.

The way that it is being spent is essentially that, in some cases it is replacing money that existed so where Scott Foresman Reading was being used, for example our basal reading program, the Reading First money would be applied to that. It is typical that schools have not bought a second reading program and used Reading First money for that and essentially taken either and implemented a basal reading program or they have taken the money that they have had and they have continued to buy the basal reading program they have had.

So, Scott Foresman Reading is approved in Reading First grants in multiple districts across the country and most of the states in the United States. So, that's the way the money comes into the market, the way the money is being spent, it is some replacement and some additional.

In addition, if you look at our portfolio you've got Scott Foresman Reading, which is the basal reading program. We are also approved for Reading First with Success Maker, which is one of our online instructional systems. We are approved for Reading First with Waterford, which is a K2 reading program and we are approved for Reading First with Knowledge Box, which is a broadband video delivery. The state of Montana has adopted Knowledge Box as a teacher training platform, so their Reading First money has been put into the teacher training aspect.

So, it is coming into the market in a variety of ways. We're accessing it in a couple of different ways, with Scott Foresman with these technological products and in addition we have got research based and US DOE blessed Professional Development platform called Lesson Lab, which also will take some of the money of Reading First.

So, a broad portfolio, a lot of money coming into teacher training and, some money into materials, the 5% that we're showing there really reflect sort of the core market in both territory and state adoption. State adoption is having the biggest effect on what is going on in that market this year.

Unidentified Participant

So, if Reading First does come in, then that could be all?

Steve Dowling

It could be a little bit additional, but mostly we have accounted for it. Again, where we are in place with Scott Foresman and these programs we're picking up that money as people buy those programs.

Marjorie Scardino

I think the important thing to remember is the huge amount, and nobody had really thought so much about the huge amount, that is just administrative work and the cost of doing it and all of the substitutions, and that is probably more than a third, according to some people. So that really does reduce the possibilities.

Jeff Meys, UBS

I have two questions. One, could you talk about the pre-publication spend. In 2003 if I read it correctly it is flattish in dollar terms. What would it be for 2004, what kind of increase would you see there?
Then a question, you're probably not going to like this one, but on IFRS. Share options, what would be the impact, just roughly speaking, of expensing in share options.

Rona Fairhead

Can I just give a quick [indiscernible] Andrew [Midgeley] if I can see him, for the share options. The amount?
Okay, about £30m.
Pre-publication costs, sorry. We expect them to go up a little bit. In terms of the amount as a percentage of sales, they have increased a little bit year-on-year to 6.4%. We would expect it to increase a little bit more, just ahead of the big 2005 investment, but we're not talking significant shifts in 2004.

Marjorie Scardino

If you follow our operational efficiencies story, you'll understand that we're getting a lot more for a lot less money.

Paul Sullivan, Merrill Lynch

I have three questions if I may. Just to follow-on from Jeff's question on pre-publications, could you just perhaps just quantify your thoughts on cash conversion excluding TSA in 2004?
Then, secondly just a couple of questions on pricing, first of all in the Professional Testing and Government Solutions business, what you're seeing there in terms of pricing, given that you've taken some market share. What is driving those gains other than you being competitive on pricing?

Then, secondly, on the College business again, talk about pricing trends there. What are your thoughts on Thomson's announcements of recent selected price cuts?

Marjorie Scardino

Why don't we take the Higher Education pricing first Will?

Will Ethridge, Pearson Higher Education and Professional Publishing Group President

Well, there has clearly been a lot of noise about pricing, and we care very much about the cost of higher education. It is important to note though that there are some inaccuracies and the noise is not exactly fair.

Our approach is really to focus on choice and value. So, we provide brief books that are inexpensive, we provide the full-comprehensive, we provide online, we provide print, we provide in bundles, and we provide stand alone. Then value is really defined as "how central is a product to a course? Does a professor teach from it? Do they use a lot of it?" If they use a book pretty much every day, its really central to the course that comes down out of that, $2.17 a day. So it is very good value.

One of the reasons we're outperforming is we've really been a leader in choice, we've been a leader in value. Our customers; clearly a way to make something central, the book is organized around the course. Objectives, when you link content to assessment, to services, as we're doing with our text-web model, which we've really innovated, and that is a way to make our products really central.

So, we actually think this whole pricing issue is a way for us to really take more share, and it is a good environment.

In terms of overall price increases, I think they will be moderate. The fact that we have been very efficient about taking our costs, we can be a little bit more moderate growth, build prices may be 1-2% and yet still our margins would be very healthy.

So, actually we think this is an opportunity to provide more value and gain more share.

Rona Fairhead

I think our cash conversion will at least go past the 80% threshold we have always had and, I think we're pretty comfortable about that. So that's we're we are.

In terms of pricing pressure on our contract businesses. Typically we go through a very rigorous assessment in terms of the profitability of each of these contracts and, typically these contracts are in the 10- 15% range. So, what effect you're seeing is the build-up of contracts, because depending on where you are in the contract and how much is flowing through, you tend to have earlier investment and then as you build it you increase your profitability.

We would expect, through the cycle a 10% to 15% profit on both those types of contracts.

Marjorie Scardino

It is important to know that we don't win these contracts by bidding a low price. We win them by bidding the service. We have testing ability, we have large scale data management ability and we have begun to win these contracts because of our reputation in those areas. Because we are the most efficient operator, because our data centres work so well. That is why we won the GMAT because we were just a more efficient delivery vehicle and because of our testing centres. So, that's the impact, not low prices.

Alex Debut

I just wondered, taking into account this bumper year forecast for the School market in ’05 and then taking into account your current School divisional margin of 10.8%, which I understand is a composite of various different businesses anyway, but what sort of leverage would you have on that margin in ’05, given the very, very strong top line you’re talking to, and also taking into account that I think the peer group is comfortably ahead at that EBIT margin level?

Marjorie Scardino

Well, let’s just remember that our basal business, which is half the School market, half the School business, is at an 18% margin and typically has been. It is our businesses in that unit, the testing business, which has been flat, as those other new contracts begin to ramp up, obviously that margin will rise. Supplemental business, which has been down and the Software business, which is just beginning to come into its own, it is the vehicle for not only online delivery of embedded testing, but also our vision of integrated learning.
So their margins are going to rise, we have just been a little bit more adventurous in our School business I think than our competitors, and that is why, but our basic business has the same kind of margin, maybe a little bit higher.

Rona Fairhead

If you turn it in terms of leverage, the Software business has gone from small losses to a little bit of profit, and that clearly has pretty high operational gearing. If you look at the School business, you’ve probably got somewhere around around 50% fixed costs, 50-55% that sort of region, so you can work out for your own self, what you’d expect the impact to be.

Unidentified Participant

A couple of macro questions. Basically on the US budget issues, you appear confident that that was all a bit of a one-off in the way that you put that. How far ahead can you predict that, if you like?
My second question is perhaps a more long-term one; how much further can you go on costs? Is this the type of business where outsourcing can be extended to – or how far can outsourcing, if you like, be extended within the publishing business?

Marjorie Scardino

Steve would you like to address about state budgets?

Steve Dowling

I can’t tell you who is going to win the election, but half as many of the states are in deficit position now, as they were a year ago. Tax receipts are at record levels and so the state budgets are starting to turn around. You are seeing the legislators, as Marjorie mentioned the 3%, if you look at the states and the past budgets through the spring legislators’ session, you’ve seen budgets go up 3%. These budgets will start to be implemented, usually on July 1, there are only three states that aren’t July 1, I think.
So you will see that carry into this year and into the ’05 fiscal year. I think that will carry on into the future, nothing is certain, but certainly there has been a real turnaround in the state budgets and the collection. Federal Government spend is up 32% on education in the last two years. If the

democrats are elected, Mr. Carrie is elected, he has been a supporter of NCLB since day one. Of course the democrat's intention is that NCLB is not adequately enough funded, so I think you will see more funding come out of Federal Government there.
So, without being totally prognosticator here, it looks fairly positive.

Marjorie Scardino

You should also remember that in 2003, when everybody was completely worried about state budgets, and we talked about almost nothing else, the rise in the expenditure for materials ended up being 2%. So I think that states do try to protect school materials if they possibly can.
In the states that are in deficit the only one that is a worry would be California. The Terminator has already doubled the amount that he is putting into education, so he says, so that seems a good sign.
Your other one was about, how far can we go on costs? I think that we think that there is a lot to go. We already do quite a bit of outsourcing. We outsource our software development, we outsource some of our technology functions and that has been a real boom for us in trying to save costs. But we think that it is a continual thing and we will continue to try to move our costs up, particularly in our variable costs.

Unidentified Participant

[Off Microphone]

Marjorie Scardino

Yes, we think that you ought to be doing these things. You ought to be taking the cost of them through the P&L and you ought to be moving your company ahead in efficiency all the time.

Jonathan Barrett

I have a few questions on Penguin. The first one really is about what drives growth in 2004? Last year you brought out a range of books which had higher ticket prices and were shooting for bigger volumes, some of that was obviously successful. Could you just tell us about why the business growth this year specifically, whether it is the extra channels or whether it is the same as last year?
Secondly, if you could just quantify the additional channel costs and give us some feel of what scale of investment you're making there?

John Makinson, Chairman and CEO of the Penguin Group

Well on the growth it won't be the new channels significantly in 2004, there will be some incremental revenue from their investments inthe second half-year, there won't really be anything in the first six months of the year, but they won't be material.
The two principal areas of growth that we will be looking for are firstly the impact of the new imprint that Marjorie talked about in the presentation. We're going to get a full-year from the Portfolio, the business imprint, and Gotham the non-fiction imprint. Godoff's Penguin Press began publishing right at the beginning of January, so we get the full-year effect of that.
They will more than offset the absence of a Tom Clancy this year. We don't have a hard copy of Clancy, we will in 2005. So, nontheless the absence of a Clancy it tends to be a very significant factor all-in-all.
In the UK we will get a Jamie Oliver this year, our biggest author in the UK. We didn't have an Oliver, as you know, in 2003.

So if you look at the front list altogether, it should net out to some growth in 2004 and the back list we are expecting to perform more strongly in 2004 as some of the destocking that was undoubtedly happening in back list channels, particularly in the United States in 2003, works its way through the system and we are starting to see a higher level of back list reorders in the orders in the first couple of months of 2004.
So, net growth in the front list and some improvement in the back list, but I don't want you to get carried away. We're seeing some growth there but this is Penguin.

Marjorie Scardino

We don't want to do everything over the top. The channel costs?

John Makinson

The channel costs will be made with a small number of millions of dollars. So, if you were to reckon on \$3-\$4m as a number that would be about the end number.

Jonathan Barrett, Teather & Greenwood

Okay. Just one quick follow-up question. Will the actual volume of key titles increase this year? I think last year you gave us a number of key titles and basically said it would be the same number. Is that number changing this year?

John Makinson

The number will be about the same. We are going to publish more titles altogether, principally because of the new imprint which is coming on screen, you have to publish an awful lot of books to make up for one Tom Clancy for example. So, there will be more books being published, slightly more books being published altogether. The number of key titles I expect will remain roughly consistent with 2003.

Jonathan Barrett

Thank you.

Unidentified Participant

I have two questions, a numbers one and a strategy one on the FT. Rona you have £235m of costs in the FT newspaper business. Could you tell us within that how much was what you characterize as investment spending? I think Marjorie spoke about the fact that one of the reasons there were losses was there was investment spending in there. Can you say how much that was please?
Then, for 2004, could you tell us how much incremental cost saving is currently in the bag for 2004, compared with 2003?
On top of that, because it is related, you've given us the guidance that with a flat advertising environment, you'd see a £20m decrease in the losses. Could you give us the other parts that we need to work out what's going on? Is there an increase there in other revenue, or is it the fact that you have got a £20m decrease in either investment spending or costs? So that's the numbers question.
Then Marjorie the strategy question is, one has heard some people saying that the Financial Times is no longer must have information in the way that maybe it was 15 years ago. Could you talk a little about whether or not you see that to be a valid criticism and, if there is any validity in it, what you're going to be doing to address that point?

Rona Fairhead

In terms of investment, I think we said at the beginning of the year it would be, for 2003 about £10m net and it was in that range. We will continue to invest in 2004. But the number that I quoted, the £20m of cost savings, has already netted out any additional investment. So that's the net. In terms of the difference that you're trying to catch, what we're saying is that is basically about this view that you take about the advertising cycle. Advertising is around 70% of our business and we say that over 80% of any uplift in advertising will flow straight through to the bottom line. So I think that's all I say, because we, as you know, wouldn't make any forecast about what is going to happen in the advertising recovery.

Marjorie Scardino

I guess first the way I'd answer that is that I don't accept your premise. I have heard just as many people say that the FT is better than it has ever been, as I've heard say that. I think what may cause that feeling on your part, and perhaps the three other people who might agree with you, is that we have been moving this from a UK paper to a global business brand, as I have said. So, we really are emphasizing our global coverage and we're emphasizing being useful and relevant around the world. That means emphasis on FT.com, it means emphasis on editing through the day, it means our Asia edition and it means working in Europe. So, maybe that has caused us to have a little bit less UK news.

The other refutation I would make is the growth of FT.com. It does seem that 74,000-75,000 people, and most of them are in the UK, find it impossible not to do without having the data and the material that we have on the FT. So they are paying us in order to have access to that. So the UK audience tends to use the paper for more directly work related material and that's must have. I think that would be the change that we've seen. We now can know exactly what that audience is doing because of the ft.com usage.

Olivier may want to add to this?

Olivier Fleurot, Chief Executive Officer, Financial Times Group

Well, as a matter of fact, in all the surveys that we have, when you ask and when you compare all international publications and you say "what is an essential business reading?" They say the FT is by far the most essential business reading. So that answers I think you question about the must read.

The reputation and the visibility and the awareness of the FT in all markets has never been as high as it is now. Even in the US it is much higher than it was 5 years ago. In the Mendleson survey we have been seeing an increase in readership.

Marjorie Scardino

It doesn't mean we wouldn't like the UK circulation to go up more.

Unidentified Participant

Can I just follow-up on that FT.com comment. You said most of the subscribers are in the UK. Do you think that those are people then that have given up the print to become paid online subscribers? Or are you actually getting new people and younger people?

Marjorie Scardino

I would say that I think it is around about, just over half are in the UK.

Unidentified Participant

Is it actually generating a new audience or is it substitution?

Olivier Fleurot

Yes, it is about 55% of all of our online subscriptions are in the UK. We see very, very little evidence of any cannibalization. You're right, we are reaching younger readers. On average our readers are younger, the online subscribers. But the bundle subscription offer that we have is the most successful of all the marketing tools. So people like to buy both print and online.

Unidentified Participant

Can I also follow-up another question then, just to understand the £300m of new contracts in Schools Testing and £600m in the Professional division. Does that work out to about £100m extra revenue in Professional in 2005 and about £70m in Schools? These are multi-year contracts, I am just trying to work out what kind of additional step-up in revenue you get in 2005, because I believe they all start in 2005, is that right?

Rona Fairhead

Yes. There will be a very small amount in 2004 and in 2005. The issue will be are they replacing other contracts that might be ending. So you can't just take that number and add on top.

Unidentified Participant

You can't help us a bit more with what kind of…?

Rona Fairhead

No, I think if you just look at the base and you say that 75% is already contracted, I think you can make your guess in terms of that.

Marjorie Scardino

The Professional Testing business, however, as you realize was a much smaller business, so £600m is going to be a pretty big number for them.

Charles Peacock, ABN Amro

I have a couple of questions on Dorling Kindersley and then another on the FT. On Dorling Kindersley and Penguin I'm afraid. Could you break out the growth between Dorling Kindersley and Penguin that was achieved in 2003? Could you expand on what you are doing in the US with the direct sales channel, how that is expected to work?

Then, on the FT, you've talked about an 80% drop through from the additional revenues or additional advertising. Do you see with all the cost savings that have been made within the FT, a need in due course to reinvest in editorial etcetera, or are these permanent savings that have been made?

John Makinson

Yes, the growth overall Charles, looking at DK worldwide. There was growth in the DK business in the non-US market, so the international licensing markets and the UK made their numbers and showed growth. Where we saw no growth in 2003 was in the United States, as I think we have flagged fairly clearly at the half-year.

We were much more vulnerable to the back list issues that we've talked about at DK in the US than we were with other publishing businesses, because our US Penguin business is a 70% front list and 30% back list. DK in the US is almost reverse, it is about 60% backlist and 40% frontlist. So, they got hit relatively harder by this back list issue and they had sell through issues on some of the front list titles. They performed very well end of year with 24/7, which is the flagship title overall.

But DK US sales number was lower in 2003 than it was in 2002, which did bring the overall DK number down for 2003. As Rona said in her presentation, the consequence of that in the sterling number was bigger than you would expect because of the mis-match between dollar revenue and sterling costs in the DK P&L.

Charles Peacock

Right, so in overall terms, if I understand it correctly, DK was down on an underlying revenue basis?

John Makinson

On an underlying revenue basis, correct, yes. But in terms of the overall Penguin number, that was more than offset by the growth that we achieved in the Penguin businesses and that is the reason that the margin was off.

On the direct sales channel, what we are doing there is trying to develop ways of building the business, utilizing the strengths of the brands that we have, both the Penguin brand and the DK brand. Finding customers who we might otherwise not reach, customers who are not for example walking into book stores, and developing business which does not employ as much capital as publishing best selling authors.

The direct sales channel is really a party plan based model for children's publishing, particularly for pre-school publishing. We are going to be saying more about it in the month or two ahead. We're investing relatively little capital to get this thing going. We're going to build it state by state, incrementally. We have a business model for it, which looks an awful lot different from the predecessor model DK-FL, which you may all have some memories off. Partly because of that experience, we are being very cautious in the way in which we approach it. But we do think that these channels are a way of reaching new customers with relatively high margin product employing very little capital, and we control that relationship for the customer, which is important to us.

Marjorie Scardino

Olivier do you want to answer the question about, with an 80% drop through we're going to need to make more investment, or are these cost savings there?

Olivier Fleurot

As we said we have cut about £100m in total of costs, but it is a continuous process. We cut costs in certain areas, we re-deploy – for instance last year we did cut a lot of costs in certain areas, but we invested – for instance we recruited journalists in Asia, because we felt that to be a global business newspaper we needed a better Asian edition. So I think it is a continuous process. We set priorities each year.

At the moment, for instance, we are investing for the future in a new publishing system, which will be a key tool, an integrated publishing system, which will allow our journalists to publish online pages as well as print pages. This will be a very new system that will be used, that we are implementing right now.

So we are always looking at the systems, the tools and the geographic needs.

Patrick Rollins, Citigroup

I have a couple of questions. Firstly, can you give us an idea of the scale of investment in your overseas Professional Testing business this year, which you mentioned, I promise Rona I'll let you answer.

Rona Fairhead

I think what we've been looking at in terms of the P&L charge would be in the order of £5-£10m, I believe that sort of range.

In terms of investment it is probably around £15m to £20m of capital investment.

Patrick Rollins

Is that still a charge next year, or do you start to recover revenues next year?

Rona Fairhead

This new Professional contract, the DSA, that is a new contract that will be covered by some of the investment from prior year and on other contracts, but this one will obviously be £15-£20m I think in 2004.

Patrick

My second question is just on the DSA receivable. Can you give us a bit more of an idea about the timing of that? A lot of your Government Solutions business is growing very fast, I would say that the US Government is a bit of a slow payer and not that desirable a customer. What have you done in terms of safeguard, so that you're not left $150m short in the future?

Rona Fairhead

Can I just do the US Government is a slow payer. I think TSA apart, the US Government is a pretty rapid payer. The TSA is a very exceptional contract and I think if you remember us standing up here a couple of years ago, we said that this was a business that was good because the bills got paid on time and it is typically 60 days or sometimes even 30 days. So the Government is a good payer. I'll hand to Marjorie on the TSA itself.

Marjorie Scardino

Well, on the timing of the TSA, it is quite normal to have an audit in Government contracts, this audit has taken them 13 months. Not that that means it has been a big or difficult audit, it is just that it is a brand new division of the US Government. They have had three changes of management since we have known them. We have finally got preliminary findings on the audit last month. There is nothing in there that looks like it's any obstacle to our getting paid, so we completely expect to be paid. It has just been something of a bureaucratic nightmare with them.

Basically as Rona said, none of the others of our customers in the US Government act this way, but we do fully expect to be paid.

Unidentified Participant, BNP Paribas

Can you please quantify the revenue decline in your Supplemental business and where do you see that in 2004, what have you done to try to address the issue?

My second question relates to the way instruction materials have been funded. Can you talk about the differences in terms of how you do business, maybe in terms of competitive landscape between states where there are categorical funding available for instructions materials and states where there is no such categorical funding available? Maybe if you could tie that into a comment with the proposals in the budget of California to eliminate designated funding for instruction materials please?

Marjorie Scardino

Yes, that's a good question. Steve has been out to California several times.

Steve Dowling

Okay, I think there was a general trend in the Supplemental business last year that all publishers experienced and that is that because the budgets were tight, the focus was on buying basal materials. The basal material, if I can remind you, is the core curriculum material that is designed to cover all of the standards that a state requires, that's what we put into these books.

The Supplemental material typically do as they say, which is they supplement the practice here and the practice here and the practice here. I think what happened last year is, one, because of the focus on Basal and two, because of the requirements of NCLB and the focus on phonics and phonetic awareness and fluency and comprehension, the five principles of reading that were annunciated in the law. People focused what they spent on supplemental on those areas.

So, in general the supplemental business suffered a bit. A characteristic of most people's supplemental business is that it is very strong in what is called "guided reading" in sort of literacy/instruction. That was out of favor with the Federal Government in terms of NCLB, so that also I think was a drag on the Supplemental business.

So, what we have done, we have probably taken about $5m running costs out of that business in 2003 that will start to show up in 2004. We have refocused them on areas that will fit the need that I just described, and that's what the publishing will be going forward. We have scaled back their plant investment to focus on those things and get them out of the larger group of discipline.

So, that was one of the characteristics of the market and I think that is what we have done going forward.

We have about 20 states in the United States that are state adoption states, the other 30 are not state adoption states. Typically those 20 states have categorical funding. You have a state like Texas, where in the constitution it says that the state must provide a text book for every student. That is one of the reasons Texas is such a great state, the text books.

Marjorie Scardino

That's only one of the reasons though, there are millions of them.

Steve Dowling

There are a lot of reasons. If you've ever been to Texas you'll know 400 or 500 of them.

So, you have those states that have categorical funding and the other states, that we call open territory, typically will have funding that is available to the school district, it is funded by the state. Remember 93% of the funding for schools comes out of state local. So you'll have funding that is designated but there is more flexibility on how it is spent, and there is no set adoption. So Ohio doesn't say everybody is going to adopt social studies this year. Mary in Ohio adopts this and Columbus, Ohio adopts that and so on. So that is sort of the difference I think, in the way both the way the funds are committed all at one time in one year to buy one subject versus being made available to the student on a per student basis, where they can spend the money on instructional materials.

California had been spending over $400m a year in the Halcyon days of the funding. They scaled back to $175m, is the expected budget this year. Arnold Schwarzenegger actually added $185m back, but he also is looking at – and this hasn't been decided yet – but he is looking at making more block grants rather than categorical funds, to give school districts more flexibility on how they spend their money. The good news is that he doubled the funding. The uncertain news is, if it is not categorical, will that leak into teacher's salaries or gymnasiums or football jerseys or whatever else.

Marjorie Scardino

Although that wouldn't be wholly bad for us, because we have a broad range of products and so we can – no football jerseys, but… Thank you all very, very much for coming. As always Luke and Rona and I are all available to talk to you.