Chief Executive's strategic overview

We are pioneering new forms of digital learning

John Fallon
Chief Executive

Dear fellow shareholders,
After over seven years as Chief Executive, and more than 22 years with the company, I will be retiring from Pearson later this year. I'd love to be retiring with the flags flying high, and the share price performing well. Sadly, that's not currently the case. I do believe, however, that, in time, we will all see the benefits of the huge amount that has been achieved over the last few years – and that the company is increasingly well placed to capitalise on what is proving to be a long and difficult transformation.

The power and the purpose of digital learning

Pearson's purpose is as strong and powerful as at any point in the company's 175-year history. Our business model – to grow and prosper as a company by enabling millions of people around the world to grow and prosper throughout their own lives by providing a digital platform that makes learning engaging, rewarding and affordable – is highly sustainable.

In one of my first Chief Executive reports, I argued that digital learning would be one of the great global growth opportunities of the next 20 years. I believe that even more strongly today. The exponential pace of digital change – and the impact of artificial intelligence and machine learning on the world of work – will require all of us to acquire fresh knowledge and learn new skills throughout an ever-longer working life.

One important way to meet this need is by combining relevant content with assessment, powered by technology, to make learning more adaptive, personalised and accessible. As the world's digital learning company – 66% of our £3.9bn in annual revenues last year were digital or digitally-enabled – Pearson is better placed than anyone to do this.

The challenge and the opportunity in US Higher Education Courseware

In the short term, however, our progress has been overshadowed by the fact that, as America's leading college publisher, we have first had to work our way through arguably one of the most challenging of analogue to digital disruptions yet faced by any part of the media sector. We will survive it with our market leadership intact, and, with an overwhelmingly digital business, well placed to grow again. But it is proving to be a very painful journey to get there.

The 24% of Pearson that is still in US Higher Education Courseware declined last year by 12%, more than we guided to at the start of the year, as students embraced digital over print much more quickly. Digital revenue grew, but textbook sales fell close to 30%.

In 2010, we had a $2bn US Higher Education Courseware business, split 75:25 between print and digital. By 2022, we expect to have an almost fully-digital[1] US Higher Education Courseware business well set to grow again.

Every industry is being disrupted in some way by technology, and ours is no exception. 10 years ago, we sold 21m textbooks to American college students; last year, we sold fewer than 4m. The college textbook has not been disaggregated in the way that the music album was – which saw music revenues decline significantly from peak to valley before now starting to grow again. It has not been displaced by 'free' models of the sort that has reduced newspaper advertising revenues dramatically and ensured analogue dollars become digital cents. Nor have we suffered a Kodak 'moment', pushed into obsolescence by the digital revolution.

This year, a third of all courses taught in American Universities will use our content and homework tools, just as they did a decade ago. In fact, use of these resources is greater now than it ever was. We have 8m platform subscriptions a year for our digital courses, which enable students to complete assignments and receive feedback, 35% more than a decade ago. In addition, students use over 2m eTexts, with all the rich content and pedagogy of our textbooks, at a cheaper price and a fraction of the weight. The level of engagement – in faculty use and student feedback – is greater than ever. And, students are willing to pay – $80 for a fully adaptive platform-based course; $40 for an eText.

So, why has our US Higher Education Courseware revenue halved in ten years? If our digital products are now deeply embedded in the workflow of our customers,

Laying the foundations for growth

Deconstructing decades of complexity to build the foundations for Pearson's transformation into a platform-based company, to become the winner in digital learning.

Legacy

Simplification

Global property portfolio reduced by net **30** properties
c.2,500 applications decommissioned
81 data centres closed
1 ERP system running 80% of Group revenue

c.£1bn of costs removed since 2013

Platform-based

Pearson

1 The core US Higher Education Courseware business is expected to be almost entirely digital. We also have an Advanced Placement business selling higher education content into US schools. This, together with several other smaller, non-college channels, comprises roughly c.$200m of print revenue which has been broadly stable.

shouldn't we have largely seen print migrate to digital on an orderly 1:1 basis? The answer lies in a number of factors that are specific to this market. Whilst professors decide what courseware to adopt, it is the students who buy them. This means that many of our sales go through thousands of campus stores, as well as through Amazon and specialist online retailers. And, whilst the physical textbook has an edition cycle of three to five years, a student often needs it for no more than a single four-month semester.

These market conditions proved fertile for the emergence of a highly disruptive trend – a large secondary market in the analogue product, the print textbook, enabled by technology. College textbooks have been bought and sold second-hand for decades. What technology changed was the nature of it: from some students selling back their books to the campus store at the end of the semester, to most students choosing to rent on a term-by-term basis. And, the scale of it: in 2010, the secondary market was a fraction of the size of the primary one; by last year, it had overtaken it.

Salvation rests in our own hands. The disruption has come to the analogue past, not the digital future, of US Higher Education Courseware. The future of learning will be digital, and consumer-defined. Experience, outcomes and affordability will all matter. The new Pearson Learning Platform – on which we are now launching our first products – will be the platform on which this future of learning will be built. It will enable engaging, immersive, learning experiences, that are personalised, diagnostic and adaptive. It will be fast, flexible and secure, enabling better learning outcomes at lower prices. A digital-first approach to updating features, content and tools – made for the benefit of the teacher and the learner, so the digital product is never out of date. A digital-first approach to pricing, in which students share in the financial benefits of a much more scalable, platform-based model.

Building on those 8m platform subscriptions, and 2m eTexts, Pearson will be well placed to start to regain share from secondary sales of its own textbooks – and do it in a sustainable and purposeful way.

A simpler, more efficient company

For many years, Pearson as a whole was overly dependent for profits from the US Higher Education Courseware business. The fact that we've been able to survive disruption on this scale is due to all that we have done to make Pearson as a whole a much simpler, more efficient and modern company. Over the last six years, we've reduced the cost base by around £1bn, and headcount by around 20,000, due to divestitures and restructuring. We've decommissioned around 2,500 applications, closed 81 data centres, and implemented 16 new global, scalable, cloud-based platforms. 80% of the company runs on one ERP system today – which includes our major businesses in the US, UK and Canada. We plan to start the roll out across further markets in 2020.

As a result, benchmarking the costs of running Pearson against other large companies, we are now much more efficient than we were a few years ago. It will take some time yet to fully bed in all these new systems but, as we do so, they will give us the ability to both achieve further efficiencies and provide the data by which we can engage more deeply with our learners and support them at key moments of learning throughout their lives.

Investment, innovation and growth

As a simpler, more efficient company, we are able to invest more organically – significantly more than we were investing five years ago – and we're starting to see the benefits. In spite of those ongoing challenges in US Higher Education Courseware, in 2019, Pearson as a whole was able to match prior year underlying sales for the first time since 2014. That's because the broader 76% of Pearson grew by 4% in aggregate. Our growth businesses – Pearson VUE, Virtual Schools, OPM and PTE Academic – grew by 8%. We also performed well across our wider assessment and courseware businesses, where the majority have stabilised or grown.

Innovation and investment have come in many forms across the company in the last year:

› We launched Aida, the world's first AI-inspired calculus app to help maths students across the globe to apply calculus into the real world, breaking the unseen barrier to STEM (Science, Technology, English and Maths) careers.

› We exported our highly regarded UK vocational qualifications overseas through our work growing the BTEC brand in markets such as the UAE, Turkey and Sri Lanka.

› We supported the Egyptian government to digitally transform its national assessment system for high school students – Pearson's biggest assessment commercial agreement by test volume to date.

› We developed a commercial agreement with the UK Home Office for the UK Secure English Language Test (SELT), which will drive future growth in our English business.

› We agreed a partnership with Oxford University to offer new short courses for learners.

These growth businesses will continue to grow in 2020, as we invest in new forms of online education, in better, smarter, online assessments, in new AI-inspired direct-to-learner apps, and in shifting Pearson's focus to link education and employability with the workplace.

This shift will be helped by a small, bolt-on acquisition – Lumerit Education – we made last year, our first in five years. You can read a case study on Lumerit Education in the Governance report on p61. Lumerit Education helps address the issues of college degree completion and affordability. It uses data and analytics to match learner profiles to academic programmes and will support the growth of our nascent 'Accelerated Pathways' business. Accelerated Pathways works with major corporates to maximise the value of their employee tuition assistance programmes and offer education as an employee benefit, which we see as a major new growth opportunity.

A second small acquisition – Smart Sparrow, an ed-tech company which specialises in the creation of rich, interactive content – will help our Pearson eText to become much more of an engaging, interactive and personalised learning experience. The strength of our balance sheet – which our CFO, Coram Williams, talks about on p30 – means that we are able to complement increased organic investment with bolt-on acquisitions that enable us to expand into faster-growing markets more quickly. And, the work we've done to simplify the company means we can now integrate these acquisitions much more quickly and seamlessly.

A fully-focused learning company

For almost 50 years, Pearson has been proud to play our part in the publishing and commercial success of first Penguin, and then more recently Penguin Random House. At the end of 2019, we announced that we are planning to sell our remaining 25% stake to our partner, Bertelsmann, for approximately \$675m, which is expected to close in the first half of 2020. Using the proceeds, we launched a £350m share buyback programme in early 2020. Our total stake in Penguin Random House has generated c.£1.9bn in net disposal proceeds and dividends for Pearson. We know the company is in good hands and we wish our colleagues and authors every future

Chief Executive's strategic overview

success. This enables Pearson now to be completely focused on being the world's digital learning company.

Efficacy 2.0 – designing better learning outcomes and greater impact

We can be more confident in the positive impact our increased investment will have on learning outcomes because of all the work we've done over the last seven years to design efficacy into our new products and services. In 2013, we committed to publicly reporting on the efficacy of some of our largest products. We have made good progress on this journey and on improving outcomes, based on what we learned. The next generation of Efficacy builds on this to take this important work much further.

We aim to improve our impact on learning outcomes, support company growth, build public trust, and ensure our products, assessments, services and solutions are known worldwide for their positive impact for customers. You can read more about this on p27

A more sustainable and prosperous company

I see this commitment to efficacy – to holding ourselves to account publicly for the learning outcomes we help enable – as fundamental to ensuring the long-term sustainability of the business. It is one of the key means by which we align our business with the UN Sustainable Development Goals (SDGs), particularly goal 4 on quality education, goal 8 on decent jobs and economic growth, and goal 10 on reducing inequality. As I noted earlier, at its very core, Pearson is a company driven by a sense of purpose – we exist to empower people to progress in their lives through learning. The deeper we integrate sustainability into our business and strategy, the bigger and more positive will be the impact we have on society – and the more likely we are to prosper over time. We are publishing our new 2030 Sustainability Strategy with this annual report, building on our focus of identifying, supporting and developing people so they can reach their full potential and create a better world for us all. You can read more on our 2030 Sustainability Strategy on p16 and throughout the strategic report.

Developing our own world of talent

As we saw again last year, the power of our purpose is one of the things that sustains so many talented and committed colleagues through some challenging times for the company. I am proud of the fact that, in all the major changes we've had to make, we've stayed true to our values of being brave, imaginative, decent and accountable.

In times of great change and disruption, it is especially important, in retaining the engagement and support of colleagues, to be as open and transparent as possible – to acknowledge when mistakes have been made and lessons learned, to provide a forum in which colleagues can challenge decisions and help us make better ones as a result.

So, I'm pleased that we've strengthened the extensive ways in which we already engage with colleagues across the company with the launch of an Employee Engagement Network. This small group of cross-functional employees has been created to enable the Board and Executive team to hear perspectives on what is working and what can improve across Pearson.

We have become much more structured and deliberate in how we make Pearson a more diverse and inclusive company. We are doing this through a collaboration model, including our new Global Diversity & Inclusion (D&I) council, which I chair, a network of Employee Resource Groups, as well as a D&I advocate network underpinned by a community of practice. People come to Pearson to learn, and to grow personally and professionally. Our goal is to be the number one company in the world for learning and development. And, we are doing this by offering dedicated learning time to all of our people and access to our own world-class learning products and services.

On a personal note, I'd like to thank Coram Williams who has led the finance function with great intelligence, integrity and grit through these challenging times. He has made big strides in improving the clarity and transparency of our financial reporting. He has also been fundamental in making Pearson a simpler and more efficient company, in strengthening the balance sheet and in enabling us to invest in the future growth of the company. His key partner in that work has been Sally Johnson, our Deputy CFO. She knows the company and our markets exceptionally well, is highly regarded across the company and she is going to make a brilliant CFO.

What the future holds

Although it may not yet be obvious externally, I believe we are now on the cusp of the next phase in the Pearson transformation. One of the biggest issues the world faces today is the exponential pace of digital disruption – through AI, machine learning and automation. Indeed, this year we published our first Global Learner Survey, which not only gauges the views of learners around the world, but also gives great insights in the shifting sands of education as learners look for new ways to consume education in a digital age (read more on p9)

All this brings great opportunities, but it brings great challenges too. The disruption is hollowing out many middle-skill jobs, it risks bringing much greater economic and social inequality, and it demands that society embraces lifelong learning.

This gives Pearson a very special opportunity. The world needs a learning company willing to hold itself to account for the learning outcomes its products enable. It needs a company with the relationships around the world – the emergent ecosystem – to have an impact at scale. And, it needs a company that defines lifetime value to help influence millions of people through a lifetime of learning.

An exciting future is in store, where we are empowered to make a direct connection with tens of millions of learners at a key moment in their lives and become their trusted partner. We now have the balance sheet, cost base, platform, capabilities – and the product pipeline – to go after that future very aggressively, and that's what we are going to do. We have invested the proceeds of our simplification programme in digital learning. Now, we must unleash its full power.

As the company enters this next phase, I think it will benefit from a new leader, with a fresh perspective, which is why I've decided to retire by the end of 2020, once the Board has appointed a new Chief Executive, and after an appropriate transition. In the meantime, of course, I will continue to do everything I can to help bring the full benefits of digital learning into view as quickly as possible.

As this is my last annual report before I retire, I would like to thank all my colleagues, past and present, our partners and shareholders for their support throughout the years. Pearson is a very special company, which I have been enormously privileged to lead. There is a lot still to do, but I'm confident that, with the platform we've built, better days lie ahead.

John Fallon
Chief Executive