The McGraw-Hill Companies

The McGraw-Hill Companies
1st Quarter 2003 Earnings Conference Call

Prepared Remarks
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The McGraw-Hill Companies

Thank you. And good morning and thank you to everyone in our global audience for joining us here at McGraw Hill headquarters as well as on the phone and the Web, for this morning's announcement of The McGraw-Hill Companies first quarter 2003 earnings. I'm Donald Rubin, senior vice president, Investor Relations of The McGraw-Hill Companies.

With me today are Harold McGraw III, Chairman, President and CEO and Robert Bahash, Executive Vice President and Chief Financial Officer of the Corporation.

This morning we issued a news release with our first quarter 2003 results. We trust you have all had a chance to review the release. If you need a copy of the release and the financial schedules, they can be downloaded at www.mcgraw-hill.com/investor_relations.

Before we begin, I need to provide certain cautionary remarks about forward-looking statements. Except for historical information, the matters discussed in the teleconference may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including projections, estimates, and descriptions of future events. Any such statements are based on current expectations and current economic conditions and are subject to risks and uncertainties that may cause actual results to differ materially from results anticipated in these forward-looking statements. In this regard, we direct listeners to the cautionary statements contained in our Form10Ks, 10Qs, and other periodic reports filed with the U.S. Securities and Exchange Commission.

We're aware that we do have some media representatives with us on the call. However this call is for investors and we would ask that questions from the media be directed to Steve Weiss in our New York office at (212) 512-2247 subsequent to this call.

Today's update will last approximately an hour. After our presentation, we will open the meeting to questions and answers.

I now introduce the chairman, president and CEO of The McGraw-Hill Companies, Harold McGraw III.

Harold McGraw III
Chairman, President and CEO
The McGraw-Hill Companies

Thank you all very much and good morning to all of you. If you're joining us by the webcast or by telephone, we welcome you as well.

We completed 2002 with a strong earnings picture. Our 11th consecutive year of earnings growth. And today we announced the release of our first quarter earnings report and we're quite pleased there. Given

the seasonal nature of the education business and some timing issues in terms of the economic recovery, this is really a Financial Services quarter. And Standard & Poor's and off to an absolutely terrific start which is going to be another extremely good year for them and we're quite pleased.

As usual, I will focus on operations and then I have asked Bob Bahash, our chief financial officer, to review key financials with you. Afterwards, we will be pleased to answer any questions you may have about The McGraw-Hill Companies.

Including a 30-cent gain on the sale of ComStock, we reported earnings per share of 50 cents for the first quarter. ComStock was not a core asset and was a lower margin business in Financial Services, so we're pleased with a timely and profitable sale.

- Earnings per share from continuing operations in the first quarter came in at 20 cents versus 15 cents a year ago, a 33.3% increase,
- Income from continuing operations grew by 33.5%, and
- Revenue for the first quarter was up 1.9%.

Traditionally the first quarter is highly dependent on our Financial Services operation due in large part again to the seasonal nature of our education operations and Information and Media Services. Given the law of small numbers, a small change can obviously have a major impact in a small quarter. Still, it is always good to get off to a good start and we have achieved that with a solid performance in Financial Services and excellent cost containment.

Although we beat the First Call consensus estimate by a penny, it is clear as we look ahead our year is back-end loaded. For reasons I'll elaborate on in the review of our operations, we expect modest growth in the second quarter followed by a pickup in the second half as the economy recovers.

Most importantly, our guidance for the full year has not changed.

We still expect to achieve the 7-to-9% earnings per share growth we originally forecasted for the year. That includes the five cents of non-cash, non-operating accounting change in the pension assumptions. I also want to reaffirm our forecast of double-digit top and bottom line growth for Financial Services operations this year.

An improving economy adds to our confidence. War and weather depressed the first quarter. But spring is here, the first phase of the war is over, and oil prices have retreated from $31 per barrel.

Interest rates and inflation are projected to show little movement from their current levels. Our economists point out that durable goods orders were strong in March, which means capital spending on equipment should resume its growth in the second quarter. Inventories are in good shape and we're seeing better ordering in the high tech industry. We can also look forward to fiscal stimulus from the government.

Adding this up, our economists see a pickup in the second half with annualized growth in the 3 ½-to-4% range after real GDP increased only 1.6% for the first quarter.

Now, let's look at operations in some detail.

Financial Services

Let's begin with Financial Services. We started the year with a solid performance in this segment.

- Revenue grew by 8.3%,
- Operating profits increased 9.6%, and
- Operating margins were 36.7% vs. 36.3% a year ago.

We expected ongoing operations in this segment to produce double-digit top and bottom line gains this year and they did so in the first quarter when you exclude Money Market Services International from the 2002 results. We divested Money Market Services in September 2002. These results were in line with our expectations.

Importantly, the results also are a testament to the effectiveness of our diversification strategy. As many of you know, we have a long-standing strategy to diversify our revenues in this area by:

- Expanding globally, now 32 locations around the world;
- Creating non-traditional products and services; and
- Smoothing the revenue stream through contracts and other fee arrangements.

That strategy served us well again this quarter and the growth in ratings revenue was outstanding.

We grew in all areas, but the strength in this environment continues to be in structured finance, public finance, international markets, and non-traditional ratings and services.

We had solid double-digit gains in all these areas, but we are particularly pleased with the outstanding results in structured finance which produced robust double-digit growth. There was strength globally in the structured finance market. Residential mortgage-backed business was particularly strong. We also had very good results in the asset-backed market, particularly in credit cards and student loans.

We very much like our prospects in structured finance, but I will touch on that in more detail later in these remarks.

About the only slow spot in the structured market occurred in asset-backed commercial paper. The slowdown in this small part of the market reflected issuer uncertainty over the application of new accounting rules for Special Purpose Entities. I should point out that fees from the asset-backed commercial paper market are dwarfed by other aspects of the structured market. We don't see this market segment as an area of vulnerability for us. In fact, there may be an upside as financial institutions restructure these instruments or shift into longer term borrowing. This all has to do with off balance sheet financing issues for banks.

Our foreign source revenue grew even faster than our domestic revenue and now represents about 33% of ratings' total. In the first quarter last year, foreign source revenue represented a little over 30% of the mix.

We also saw a pickup in the high-yield market as some investors preferred the risk and return offered by instruments to the uncertainties in the equity market. That was a bit of a surprise to us, but welcoming.

Let me quickly recap new issue volume for the first quarter. Dollar volume in the U.S. new issue market increased 11.1%, even as corporate issuance declined 5.2%. I believe this is one to watch because I think this is going to be an area of upside. I think it is also fair to say that some of that decline can be attributed to the war. We believe some corporate treasurers were holding back until the situation was clarified.

As we predicted, municipal issuance grew. Public finance was up 21.0% in the first quarter. Asset-backed issuance increased 21.1%. Mortgage-backed issuance was up 38.8%. European dollar volume issuance was up 39.2%.

In looking ahead, we believe we are on track for the full year. The refinancing boom will be with us longer than we originally expected. That trend will now carry well into the third quarter instead of tapering off at the end of the first half, a real plus for the residential mortgage-backed market.

The structured finance market looks very solid to us on a global basis. Securitization has become a major funding tool in Europe. Manufacturers are embracing it, as are leasing companies and mortgage lenders. Securitization is also playing a role in repairing balance sheets in the banking sector.

The commercial mortgage-backed market was strong in the first quarter and continues to show promise. The asset-backed market will continue to grow here and abroad. Favorable funding costs will drive auto ABS issuance and the need to refinance credit card debt will also bolster the market.

Public finance will grow as states turn to the market to avoid raising taxes or to alleviate some of that pressure.

We still expect some improvement in the corporate market later this year as the economy improves and capital spending starts to pick up.

For a longer-term perspective on ratings, I suggest you take a look at our *2003 Investor Fact Book.* It has been posted on our IR website and hard copies are going into the mail shortly. Here you will get a look at the ratings market since 1997 and Standard & Poor's market penetration each year by category. You will see that our market penetration rate of the ratable market has been steadily increasing. For example, here is a chart showing the growth of the U.S. mortgage-backed market. By 2002, the market had grown to $462 billion and S&P rated 87% of the dollar volume. You can access this information on our IR website. The URL is www.mcgraw-hill.com/investor_relations.

One final comment on ratings and the regulatory environment. We've provided testimony to the Senate, the House and the Securities and Exchange Commission on how Standard & Poor's functions in the capital markets. We've been very active in the dialog and indeed, welcomed the opportunity to clear up misconceptions about the ratings process.

As the next step, the SEC will soon issue a concept release. We don't have a date, but we think it could happen any day. It would not be appropriate to speculate on what the concept release will contain. But in broad terms, we expect some recommendations on the role and functioning of rating agencies and a call for public comment.

The process—the issuing of the concept release, the call for public comment, the creation of proposed rules, the call for final comments and perhaps more revisions—will probably consume most of this year and maybe go into next year.

The fact that the SEC is not rushing to judgment is a sign that the process is being conducted with great care. We certainly welcome more transparency in the designation process for new nationally recognized statistical rating organizations. And we are encouraged that regulators have recognized the effective role rating agencies have played for many years in the whole capital formation process. But any more comments will have to wait for issuance of the concept release.

In Investment Services, cutbacks at retail brokerage firms have had an impact on S&P's sales of equity information and services.

But we're seeing growth in index services. Assets under management based on S&P indexes hit $60.4 billion at the end of the first quarter, up from $51.5 billion for the same quarter last year.

And we've also seen a pickup in the trading of contracts based on S&P indexes. The S&P 500 E-mini set a new daily record on March 17 when 1.1 million contracts were traded. Volume is averaging 600,000 contracts per day, up from 450,000 in 2002. S&P 500 options are trading briskly at the CBOE, averaging about 145,000 contracts per day, up from 90,000 a day for the same period last year. We're paid each time a contract is traded and on basis points for assets under management in exchange-traded funds (ETFs).

We're continuing to build this business. At the end of April, Rydex Global Advisors will introduce a new ETF, the Rydex S&P Equal Weight ETF, which is an equal weight version of the S&P 500.

We continue to seek new outlets for our independent equity research. Earlier this month, Standard & Poor's announced a deal to provide equity research to Nordea, a leading financial services company operating in Denmark, Finland, Norway, and Sweden. S&P will provide research and commentary on 120 U.S. and European stocks for Nordea Securities, whose institutional customers will gain direct access to our analysts.

As the No. 1 independent research house on the "street," S&P is focused on creating new opportunities for its services. As firms evaluate what steps they will take as part of the Settlement with New York State Attorney General Spitzer and the SEC, S&P is making its case for creating more value. We've been discussing aspects of this settlement with all the firms involved in the proceedings in anticipation of the announcement made by the SEC yesterday. As you know, Wall Street firms must spend $432.5 million over five years to provide customers with this independent research. These firms are already our customers so a foundation is already in place. Now we'll just have to see what can be done to add to it. We built no revenue assumptions into our 2003 budgets. We will keep you posted on progress here.

So, let's sum up for Financial Services:
- We're off to a good start,
- We expect to see continued strength in international markets, particularly in structured finance, and
- We still expect operations to produce top and bottom line double-digit growth this year.

McGraw-Hill Education

Now let's look at McGraw-Hill Education:
- Revenue declined 1.6% in the first quarter,
- The operating loss increased by 1.4%,
- Revenue at our Higher Education, Professional and International business increased 2.9%, and
- Revenue for the School Education Group was off 6.3%.

First quarter results are never very indicative of what will happen in the education market and that's true again this year.

Softness in children's publishing—supplementary products for the educational dealer, home and school markets—was a key reason for the first quarter decline. Year-over-year comparisons were also more difficult because we shut down a coloring and activity book product line late last year.

We're getting excellent early results with our social studies programs in the secondary market. We're also continuing to have success with our *Everyday Math* program, which sold well in the first quarter.

You may recall that both *Everyday Math* and *Impact Math*, our middle school program from Glencoe, were recently adopted by New York City as part of its curriculum reform. We have just received the city's initial orders, and planning for the implementation of this massive adoption is well under way.

What's clear right now is the noise level in the marketplace about educational funding is unusually high as states come to terms with declining tax receipts and the requirement to produce balanced budgets. We've seen various estimates of the states' total budget deficit that represent the aggregation of projections made at different times and using different parameters.

46 states operate on a fiscal year that ends in June, so many legislatures are now meeting to deal with budget shortfalls for the year just about to end, and to create new budgets for the fiscal year starting on July 1. So timing of the process makes it very hard to predict the outcome now. The latest information we have is that 26 states, including the District of Columbia, do not have balanced budgets; 24 states are in balance.

Here is now we assess the situation now:

First, not all states are going to resolve all their deficit issues exclusively by cutting costs. We expect solutions also to include:

- Raising fees,
- Increasing taxes, and
- Financial engineering—raising money in the public finance market, thus the strength we are seeing in the municipal financing area.

Secondly, education is a national and state priority. At a recent State of the States review held by the nation's governors, all of them cited education as an overarching priority. Furthermore, the vast majority of the Governors emphasized the need to protect educational funding by minimizing cuts and safeguarding base-level funding.

Third, even when budgets are reduced, the cutback in education will be less severe. And even when total education spending is reduced, instructional materials are usually trimmed less, particularly in adoption states where funding for instructional materials is very visible.

Fourth, the focus on state education budgets overlooks the importance and continued strength of local funding. Property taxes are the key factor in local funding and the housing market has been solid. Local funding plays a significant role in instructional material funding, particularly in open territories.

Consider what is happening in Kentucky, which recently postponed its K-8 math adoption. That was worth about $13 million this year. The high school market in Kentucky was always funded locally. And we still expect local school districts will purchase math with local funds, so some revenue will be generated in Kentucky this year.

And fifth, the infusion of federal funds from the No Child Left Behind Act *will also be a factor this year.* We know that 30 states have already received $541 million for the implementation of *Reading First* programs, creating the equivalent of a large and eventually national adoption program for reading in the K–2 market. States are beginning to make sub-grant distributions. That list includes 8 states: Florida, Illinois, Michigan, Pennsylvania, Ohio, Alabama, New Jersey, and California.

The entire opportunity created by *Reading First* won't be realized in the first year, but we believe enough funding will reach local school districts to help mitigate state funding issues. After administrative costs, the funds will be spent for materials, assessment, and training.

We believe McGraw-Hill Education is particularly well-positioned to provide the materials and services schools will need to meet the program requirements. We know at this moment, for example, that tests from CTB/McGraw-Hill are being approved for mandated *Reading First* assessments in 10 states, with more to come.

We're starting to see some orders based on *Reading First* funding. For example, ten schools in Mobile, Alabama used *Reading First* funds to place an order for our *OpenCourt* reading program. This is new funding.

A lot of these state funding issues are not going to be resolved for a couple of months. Take Texas, where the legislature is even now considering school budgets for instructional materials. The current regular session of the Texas legislature ends on June 2 and we expect the debate on educational funding will come down to the wire. In recent years, Texas has tended to place orders late in the second quarter. So the legislature's decision could affect the timing and the size of sales in the second quarter, as well as the third quarter and the year.

Given all the complexities, we still expect the K-12 market to grow this year.

We continue to like our prospects in the higher education, professional and international markets. Our higher ed products are traveling well and the combination of texts and technology has created a competitive advantage in the marketplace here and abroad. All our major titles come with wraparound software. In the new *Investor Fact Book* you will see an example of how we enrich one of our classics, McConnell and Brue's *Economics,* with tutorials to course-specific news feeds.

We still believe the higher ed market in the U.S. will grow 6-to-7% and we expect to outperform it.

So, let's sum up for McGraw-Hill Education:

- Growth in the el-hi market as federal programs help mitigate state funding issues,
- 6-to-7% growth in the higher education market,
- Growing application of technology to create a competitive advantage.

Information and Media Services

Now, let's look at our next segment, Information and Media Services. Revenue for the segment decreased 5.2% but operating profits increased by 4.3%.

This management team headed by Scott Marden continues to do an excellent job in managing costs and improving our leverage. As a result, the operating margin in this segment improved to 7.2% in the first quarter versus 6.5% a year ago. Let me assure you that rigorous cost management will be a hallmark of this segment all year.

In assessing our first quarter results, let's not forget that advertising this year actually got off to a promising start in January. The early signs for us were positive:

- *BusinessWeek* ad pages were up 11.0% in January,
- Broadcasting benefited from the Super Bowl.

But we are all aware of the impact of geopolitical events. As a result, advertisers pulled back.

Broadcasting's promising start flattened out and revenue for the first quarter was flat versus last year. With one more issue in this year's first quarter, *BusinessWeek* finished ahead by 2.2% in North America, but revenue from overseas, particularly in Europe, fell off.

Ad pages in most of our other publications were also off, *Architectural Record* performance is a notable exception. This publication, edited by Robert Ivy, is one of our jewels. That's why *Architectural Record* recently received three major industry awards for best editorial writing, best single issue of a magazine, and best themed issue.

In general, though, we are expecting the first quarter softness in advertising to have some spillover effect in the second quarter. For example, in April *BusinessWeek* ad pages were down 30.3% and the publication after four months trailed last year by 10.3%.

But the real question now centers on the pace of recovery. We see some reassuring signs. Pacing has improved at Broadcasting in May. It's up in the mid-single digits and the quarter looks positive. What happens in June will be very important.

There are some very early signs of a pickup later in the second quarter at *BusinessWeek*. Advertisers who pulled back or waited on the sidelines are starting to come back. Such developments are hard to measure, but we are encouraged and we're seeing May and June bookings pick up.

BusinessWeek has retained its lead as the best-selling business magazine in the world. Period. Circulation is at an all-time high at 987,000 in North America, even as we've raised annual and three-year subscription prices. One-year subscriptions are up 9% to $59.97 and three-year subscriptions are up 20% to $119.97.

We are well-positioned to benefit from an upswing in advertising. And we believe the stage is being set right now for a pickup in the months ahead.

In our business-to-business verticals, we're looking for some improvement in construction, energy and aviation. But softness in the clinical publications in the healthcare area will probably take a little bit longer.

Let's sum up for Information and Media Services:

- Stringent cost controls will be in place all year,
- Second quarter advertising starts slowly,
- But there are signs of a recovery in advertising late in the quarter and clearly our expectations are higher for the second half.

And therefore summing up for The McGraw-Hill Companies overall:

- Our guidance for the year is unchanged: 7-to-9% EPS growth, which includes that five cents non-cash, non-operating charge for a change in pension accounting assumptions;
- Due to geopolitical events and the resulting effect on economic conditions, we do see some shift in quarterly performance into the second half;
- Continued strength in Financial Services with continuing operations producing double-digit top and bottom line growth for the year;
- Early signs of a second half recovery in advertising;
- Federal programs will help mitigate state funding issues in the K-12 market, which will show year-over-year growth;
- The higher education market will grow 6-to-7%.

That completes the operational report for the first quarter. Let me turn it over to Bob to give some key financials and then we'll go into any direction you like. Bob.

Robert J. Bahash
Executive Vice President and CFO
The McGraw-Hill Companies

Thank you Terry.

The company continues to maintain a strong financial position. So let's start this morning by reviewing some of the key factors that contribute to this strength.

Total debt at the end of the first quarter was $591.7 million. That's $13.3 million higher than year-end debt and $493.6 million lower than debt at the end of March last year. We have kept our debt in commercial paper to take advantage of low interest rates. As a result, interest expense decreased 58.3% to $2.7 million in the first quarter. That reflects the reduction in interest rates and debt levels from last year. Our average interest rate on commercial paper borrowings for the first quarter was 1.3%. That's down from 1.9% last year.

In the last two years, as part of our best practices effort, we have improved our collection process for accounts receivable. We made some more progress in the first quarter. As a result, cash provided by the decrease in accounts receivable in the first quarter was $56 million more than the same quarter in 2002.

We also reduced our blended tax rate from 37.5% to 37.0% in the first quarter. You should anticipate that lower rate for the remainder of the year. The primary reason for the change in the effective tax rate was an increase in foreign source income which is taxed at rates lower than the combined federal and state rates in the U.S.

Our capital expenditures increased in the first quarter. Capex—what we spend for property and equipment—came in at $13.2 million, up $3.8 million from the same period last year. Spending in this category will ramp up later in the year as we prepare to occupy our new building in London's Canary Wharf. Construction is being completed. We expect to start moving employees into the new facility at the beginning of next year. With the expected $50 million required for the Canary Wharf build-out, we estimate capital expenditures will reach $175 million for the year.

Pre-publication costs for the first quarter were $38.6 million, up $3.7 million for the period. Here, too, spending will ramp up. We expect to spend about $285 million this year.
Now, let's look at some non-cash items:

- Pre-publication amortization declined in the first quarter to $31.6 million. Last year, it was $33.1 million.
- Depreciation was $21.2 million, down from $23.7 million a year ago.
- Amortization of intangibles was $8.7 million, down from $9.9 million last year.

You will see $7.7 million for additions to technology projects in the cash flow statement, which is down from $21.9 million in the first quarter last year. A lot of this has to do with projects for the Education segment, as well as the Financial Services segment, including the Global Transformation Project (GTP) in McGraw-Hill Education.

GTP has recently undergone an intensive review. To support McGraw-Hill Education's global growth objectives, we have decided to expand the GTP project in scope and complexity. We anticipate the enhanced project will now cost $180 million, up from an estimated $140 million for an earlier version. The increased spending will provide:

- Enhanced features for customer self-service,
- The development of an electronic business-to-business catalog, and
- New and enhanced features for the global data warehouse.

These are among the features that will improve efficiencies and provide the basis for increased revenue.

Our current schedule calls for a rollout in the U.S. school units in 2004 and the Higher Education and Professional Publishing units in 2005. The International units will be completed during the 2005-2006 time period, at which time we will begin to realize the benefits from implementing the system on a global basis.

Now, let's spend a minute on stock buybacks. We've been active in the first quarter, repurchasing about 1,584,000 shares for $84.8 million at an average price of $53.57 per share. There were no purchases in the first quarter last year. For the full year, we still expect to buy back 3.0-to-3.5 million shares.

Thank you.

"SAFE HARBOR STATEMENT UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995"

This section includes certain forward-looking statements about the Company's business, new products, sales, expenses, cash flows, and operating and capital requirements. Such forward-looking statements include, but are not limited to: future paper, printing and distribution prices; compensation increase rates; pension plan income; the strength of the U.S. and global economy; Educational Publishing's level of success in 2003 adoptions and enrollment and demographic trends; the level of educational funding; the level of education technology investments; the strength of higher education, professional and international publishing markets and the impact of technology on them; the level of interest rates and the strength of the economic recovery, profit levels and the capital markets in the U.S. and abroad with respect to Standard & Poor's Credit Market Services; the level of success of new product development and global expansion and strength of domestic and international markets at Standard & Poor's Investment Services; the level of merger and acquisition activity in the U.S. and abroad; the strength of the domestic and international advertising markets; the volatility of the energy marketplace; the strength of the pharmaceutical marketplace; the contract value of public works, manufacturing and single family unit construction; Broadcasting's level of political and other advertising; and the level of future cash flow, debt levels, capital expenditures and prepublication cost investment.

Actual results may differ materially from those in any forward-looking statements because any such statements involve risks and uncertainties and are subject to change based upon various important factors, including, but not limited to, worldwide economic, financial and political conditions, currency and foreign exchange volatility, the health of capital and equity markets, including future interest rate changes, the level of funding in the education market (both domestically and internationally), the pace of recovery of the economy and in advertising, continued investment by the construction, computer and aviation industry, the successful marketing of new products, and the effect of competitive products and pricing.