The McGraw-Hill Companies
3rd Quarter Earnings Conference Call - Prepared Remarks
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The McGraw-Hill Companies

Good morning and thank you everyone for joining The McGraw-Hill Companies for our third quarter 2001 earnings meeting. 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.

This morning we issued a news release with our results for the third quarter. We trust you have all had a chance to review the release. If you need a copy of the document, it can be downloaded at www.mcgraw-hill.com.

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 Form10-Ks, 10-Qs, and other periodic reports filed with the U.S. Securities and Exchange Commission.

We are 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 and welcome to this morning’s call. A few hours ago, we released our results for the third quarter. They are in line with the guidance we provided earlier this month in our pre-announcement call:

- Revenue for the third quarter increased by 10.1%.
- Net income grew by 11.1%.
- Earnings per share were up 10.9%.

If you exclude four cents for the impact of dilution from the recent acquisitions and the loss of profits from the September 11th attack, our EPS improved by 14.5%. These are the results we promised to deliver.

We are still on track to deliver the year we recently forecasted. Our guidance for the year still calls for 8-to-10% revenue growth and earnings per share growth of 6-to-8%, excluding 10 cents dilution from the recent acquisitions and the loss of revenue from the terrorist attacks. If you include the impact of dilution, that means earnings per share of $2.40 to $2.45 this year and a fourth quarter range of $0.51-to-$0.56 cents.

Now, let's look at our three operating segments, so we can provide you more insight into how we produced third quarter results, despite a recessionary environment that had some influence on all of our segments.

McGraw-Hill Education

Given the third quarter and its importance to Education, let's start with Education, our biggest revenue producer.

At McGraw-Hill Education, revenue increased 17.8%, operating profits grew by 18.4%, and operating margin improved by 15 basis points to 30.6% for this quarter.

In the elementary-high school market, our products won first or second place in 30 of the 53 state adoption opportunities this year. That's 18 first-place finishes and 12 second-place finishes.

Let me be clear about this record. When we talk about the market, we include all the available opportunities to capture revenue. Not students, not districts, not units. Dollars are our measure. It appears to us that some others are sometimes more selective in making claims.

We start with a very important fact: Our School Education Group has a broader, more diversified product lineup than the competition. Put another way, it is true that we compete with other publishers, but it is also true that other publishers do not compete with us in every subject. In our view, to claim victory in a state adoption subject, we think you must win the largest share of the total available dollars and not just the largest share of a carefully defined slice of the pie. It is in that spirit that I am going to provide some more detail on this year's adoption market and our performance.

Elementary Market

In the elementary school market, nine states bought reading this year. Our Macmillan/McGraw-Hill and SRA/McGraw-Hill programs combined to capture first place in this important market.

Reading is one of our core strengths and with new products from the Tribune acquisition we are growing stronger, especially in the supplemental market. Today, we offer an unmatched range of products in this market from research-based phonics programs to authentic literature.

- Three states bought elementary social studies and we finished first,
- Four states bought language arts and we finished second overall,
- Three states bought science and we finished second overall,
- Three states bought math. We finished third because of problems in California, which I will discuss more fully in a moment,
- Three states bought art and music and we finished first.

Secondary Market (Glencoe)

- In the secondary market, seven states bought literature and Glencoe finished second—a very good performance in the second year with a new literature program, which is winning share against entrenched competition,
- Five states bought language arts and Glencoe was the market leader,
- Three states bought social studies and Glencoe finished first,

- Three states bought math and despite market-leading performances in Georgia and Mississippi, we finished third because of problems in California,
- Three states bought science and Glencoe finished third,
- Two states bought health and we led the market.

That's a lot of detail, so let me add this up for you. We believe the total elementary-high school adoptions this year represented approximately an $850-to-$900 million opportunity. That's our best estimate at this point in a year that is proving especially difficult to call because of the softening economy and the after-shocks of the September 11th attacks.

Prior to the attacks, funding cutbacks in four Southern states prevented full implementation of adoption decisions that had been announced earlier in the year. Unfortunately, the extent of those cutbacks was not apparent until the middle of the summer ordering season, after Mississippi, South Carolina, and Virginia had completed their 2001/2002 fiscal-year budgets and reprioritized educational spending for the third quarter and beyond. In Alabama, the fourth state, higher K-12 cutbacks resulted from a state supreme court decision announced on June 28.

But based on the results I have just recapped, we captured about 30% of the available dollars. Even with our performance in California and funding cuts in the four adoption states, we continued to make progress. Incidentally, excluding California, our capture rate of available dollars is projected to be about 35%.

Our ongoing strategy is to produce a broad and deep line of products for
- Academic and non-academic subjects,
- In both basal and supplementary markets,
- In testing and scoring,
- In the developing market for technology products, including those delivered online,
- And now for the emerging pre-K market.

That strategy keeps us moving ahead even when you occasionally experience problems in some markets. It worked this year and will continue to do so in the future.

It is why our core business grew this year despite the problems in California and funding postponements. All told, that cost us about $50 million in sales, or about four to five percentage points of growth. If we had met those goals, our core business would have matched industry growth rates this year. Without that revenue, we estimate our core business will grow about 4%.

So, let me take a moment now to talk about our industry growth rates. We now expect the el-hi market to grow about 8-9% this year. Through August, industry sales are up 16.7%, according to AAP statistics. But we know the figures are overstated because of changes this year in the way McGraw-Hill Education reports its numbers. This year, we are reporting depository sales monthly, instead of quarterly. The process inflates the monthly comparisons because of our size.

The Tribune figures are another issue. As best we can tell, some Tribune units last year reported sales only by quarter, some reported annually, and some not at all. This year, under our management, we are reporting these sales monthly. As a result, the percent change reported each quarter is not really based on an apples-to-apples comparison with last year, so we think the industry gains reported through August are overstated.

The Tribune acquisition added an incremental $104 million to our top line in this quarter. We had very good results with Tribune products that were incorporated in our existing units. The Wright Group contributed positively to our growth, but not to the degree we anticipated. Their products are sold by independent reps and the longer transition period created some problems for us.

As you may recall, the acquisition of Tribune Education began in January 2000 and it took about nine months to complete the sale. That's a long time for a sales force of independent reps to wonder about their future and your products. The delay also slowed the creation of new products so the pipeline wasn't as full. We believe these problems are behind us and look forward to a better performance next year, which will be a very important part of our overall Education growth next year.

Earlier, I promised to provide some perspective on what happened this year in California. I'll start with the new elementary school math program.

As part of the adoption process, math programs underwent a content review by a university-level advisory group. Even though one of our authors helped write the guidelines for California math, the review criticized our program on philosophical grounds. The criticism was officially discredited when the state board adopted our program. But in violation of state regulations, the review found its way into the marketplace. We overcame some of the problems that it created, but clearly it had an impact.

In the rest of the nation, the new math program is performing extremely well.

A different issue affected our middle school math series, which has produced an outstanding record in California since 1995. We did not submit a new program for adoption this year because our five middle school math texts already met state standards and had been approved for purchase with available supplemental funds. Late in the selling season, California offered new funds for training teachers, but limited the money to math programs adopted at the start of the year. We've worked to change that policy, but in the meantime the availability of training funds gave the new programs an advantage.

In science, few states want material sequenced the way they teach it in California. So even though we are the nation's leading middle and high school science publisher, we had some problems in California. And, quite frankly, the bottom line is that we misread the California science market and we will fix that.

Next year is a whole new ball game in California. The state is adopting reading for sale in 2002 and is calling for programs with a strong phonics-orientation. Reading is one of our strengths and we already have had a lot of success in California with our research-based *Open Court* program from SRA/McGraw-Hill. A year ago, *Open Court* scored a major victory in California, winning the huge Los Angeles Unified School District reading adoption.

The headline from the October 10th edition of The Los Angeles Times ("First Graders' Scores Surge in Reading Test") shows what our program can do. As the article explains, first graders in Los Angeles produced above average scores for the first time in reading and spelling tests. Los Angeles Superintendent, Roy Romer, who you may recall is the former Governor of Colorado, gives the credit to the *Open Court* program. With results like that, we're looking forward to better times next year in California.

We've spent a lot of time on the el-hi market, but don't forget that we are a pre-K-to-16 publisher with a very robust higher education business.

We're having another very good year in higher education. Our college and university business produced solid double-digit top- and bottom-line gains for the third quarter and year-to-date, and that's without the Mayfield acquisition. Based on estimates we've seen, the college market growth rate so far this year is about 7-to-8%. Clearly, we are growing faster and gaining market share in the college and university market.

A solid front list is driving sales. We've listed some of the key titles in our earnings release, so I won't repeat them here. But I will note that we're showing strength across the board—in humanities, social science and languages, business and economics, science, engineering, and math.

We believe our strategy of providing digital solutions to this market is a key factor in our success. More than 62,000 instructors have now registered to use PageOut so they can develop course-specific Web sites. And we are seeing the first adoption of our e-books, which are being delivered through our *Primis eBookstore*.

In Professional Book operations, we have seen continued softness in computer and trade books.

In our international operations, growth in Canada, Asia Pacific and Australia has been offset by declines, primarily in Latin America.

Financial Services

Now, let's look at Financial Services.

In Financial Services, we once again demonstrated the remarkable resilience of this business. Revenue from ongoing operations increased by 12.6% for the third quarter. That reflects the divestiture of DRI and less than one month of results from the acquisition of PricewaterhouseCooper's Corporate Value Consulting business. Operating profits grew by 10.2%, and operating margin actually improved by 37 basis points to 31.4%.

Considering the circumstances, we are very pleased with this performance. As you may know, S&P's headquarters is in New York's financial district. It was temporarily shut down following the attack of September 11th. But S&P kept working from remote locations until the building reopened the week following the attack. Most of our print products were distributed on schedule and, except for a short blip at MMSI, delivery of our electronic products went off without a hitch.

Of course, financial markets were shut down during this period and that obviously had an impact on our results.

What may be less well recognized is that the events of September 11th also affected the European bond market. The corporate sector there was the most adversely hit. Government issuance appears to have gone ahead on schedule. In this period, the market did shift toward smaller issues with shorter maturities.

By the last week of September, activity in the Euro-denominated market was returning to normal. And while the U.S. market slipped in September, it also bounced back. In fact, we believe it actually slipped less and rebounded more strongly than the European market. The revenue pickup helped improve our operating margin in this quarter.

Once again, everyone is watching the new issue statistics and looking for trends. We've provided the third quarter figures from Securities Data Corp. and Bondware in our earnings announcement this morning. What the figures show is that dollar volume in the U.S. market was up 14% and European issuance declined by nearly 26% in the third quarter.

If you combine the dollar volume figures from the U.S. and Europe, you will see that new issuance declined by about 5% for the third quarter. That's worth noting because Standard & Poor's Credit Market Services grew at a double-digit rate in this period.

That performance highlights two things about our business:

1. Our diversification strategy is working.
2. The new issue statistics don't reflect what we've achieved through diversification in global markets and through the creation of non-traditional services such as Bank Loan Ratings, Rating Evaluation Services and Issuer Credit Ratings.

In Issuer Credit Ratings, for example, we rate an entity and not its debt issuance. In fact, the entity being rated under this program may not be issuing debt at all.

In short, we have been successfully reducing our dependency on transaction volume, both here and abroad. That's an important reason why our domestic and overseas business both grew at double-digit rates in the third quarter.

For some, the diversification story is a familiar refrain. But it is the important factor that leads to steadier, more consistent, less volatile results.

For Standard & Poor's Information Services, revenue and operating profits grew modestly as our trading and index services lost four days of business when the financial markets shut down in New York.

But assets under management in ETF funds based on S&P indexes increased year-over-year for September by about 7% to $38.9 billion. We have also seen trading volume soar since ETFs are regarded as a good vehicle for taking advantage of market volatility.

At the beginning of October, we took the next step to keep growing in this area. We joined with Credit Lyonnais Asset Management to create a new partnership to list and promote Exchange Traded Funds in Europe. These new European ETFs will track the S&P Europe 350 and S&P Euro indices and their components for geographical, sector, and style indices.

On September 4th, we acquired PricewaterhouseCoopers' Corporate Value Consulting business. The transition is proceeding smoothly and there are signs that CVC's pipeline is starting to fill. That's encouraging news.

Information and Media Services

Let's now turn to Information and Media Services where the economic downturn has hit us the hardest.

Revenue declined 17.3%, operating profits were off 74.6%, and the operating margin fell by 10 percentage points to 4.45%.

Our advertising businesses obviously are feeling the impact of a recessionary environment and the cancellation of programs in the wake of the September 11th events.

At *BusinessWeek*, advertising pages were off 40.1% for the third quarter and 35.1% after nine months. The fourth quarter has gotten off to a slower than expected start. For the four issues in October, *BusinessWeek* pages are off 44%.

Local and national time sales are both off at Broadcasting, although national is off more. For the fourth quarter, pacings are off by more than 20%.

We've also seen declines at *Aviation Week*, *Engineering News-Record*, our energy publications, and in Healthcare.

There is some encouraging news. Platts, our energy information service, strengthened its already solid position in the field by acquiring FT Energy. That integration is going well.

And in construction, we are pleased with the improvements we are seeing at Sweet's, which will help fourth quarter prospects.

In face of the revenue shortfall, we're working very hard here on costs. After nine months, our costs in this segment are down by $54 million.

The Outlook

Let me close with some general observations about the outlook for The McGraw-Hill Companies. We are in the process of budgeting for next year, so it is premature to provide a forecast for 2002. But here are some things we do know:

In Education, we know that the adoption schedule next year is not as robust as this year's. But that's not the whole story. Even after the events of September 11th, there is still strong support for education reform and increased funding.

We still expect the states to increase their spending for education in the fiscal year ending in June. According to the National Conference on State Legislatures, state budgets for the el-hi market in this period are going to rise 3.7%. That's slower than last year when it grew by 6.4%, but still faster than inflation.

We expect more targeted funds from the federal government that will benefit our business. By the end of next month, Congress could pass much of the Bush administration's education reform bill. The House and the Senate Appropriations Committee recently passed their initial appropriation bills to the Department of Education for the next fiscal year. Although there is more work to be done, it now looks like there could be $900 million for Reading First, $1 billion for classroom technology, including integrated content, and $400 million for state programs to test all students in reading and math in grades 3 through 8.

With more emphasis on testing and a bigger supplemental business, products for the emerging pre-K market and a broad line of academic and non-academic products, we will continue to grow and look for market share gains next year.

In Financial Services, we're expecting another solid quarter.

We see solid growth in structured finance in the U.S. and Europe:
- The asset-backed market is generally strong in the fourth quarter and refinancing should drive Residential Mortgage-Backed Securities. We should also note that there is some concern over the timing of some larger, more complex deals.
- Favorable interest rates will continue to drive Municipal Finance.
- Investment grade corporates will continue to grow, but the high yield market will remain weak.
- The pipeline for non-traditional products such as Rating Evaluation Services is strong globally and will help our fourth quarter.

In Information and Media Services, we have shielded as much of the shortfall as you prudently can in a highly leveraged business without damaging our ability to operate effectively in the coming upturn.

The steps we've taken include:
- Discontinuing *Hospital Practice*, one of our healthcare publications,
- Employing new technology to improve productivity,
- Restructured some of our sales forces,
- And, in general, resizing operations to support current levels without harming future prospects.

As a result, we will have a leaner operation as we head into 2002.

Finally, a word about the economy. According to our senior economist, David Wyss, we're clearly in a recession. It probably started last spring and is expected to end after the first quarter of next year.

From peak to trough, David Wyss expects a decline of less than 1.0%. He points to three things that will help pull the economy out of the recession:
1. The interest rate cuts the Federal Reserve started making last January. David Wyss says it takes about a year for such cuts to take effect, so by next January, the economy will begin to benefit from the Fed's actions.
2. Increased government spending will also begin to favorably impact the economy by the first quarter next year, assuming Congress acts in a timely fashion—especially on passage of the economic stimulus package.
3. He also expects a pickup in consumer confidence next year following a lackluster Christmas season this year.

All this portends a much healthier 2002 than 2001, with much of the progress seen in the second half of the year.

On that note, I will turn over the podium to Bob Bahash, who will review the Corporation's financial performance.

Robert J. Bahash
Executive Vice President and CFO

Let's start by looking at our free cash flow.

But first it is important to understand our definition of free cash flow. As we define the term, it is what's left after internal investments and dividends, but before one-time real estate projects. This is the cash available to repurchase shares, make acquisitions, and to repay debt.

Even though our earnings won't be as robust as we originally expected, we continue to see a healthy growth in our free cash flow this year. In 2000 our free cash flow was $268 million, and we project a growth in excess of 10% this year.

We improved our print-to-sales timing, taking advantage of a softer market for printers, who have more spare time to accommodate our orders closer to the actual selling cycles. This has not only helped us to reduce our inventory requirements, but, very importantly, provides us with much better visibility of the actual market's needs and demands at the time of printing.

Improvement in our billing and collection processes will also contribute to improved working capital performance.

A few one-time factors contributing to our free cash flow in 2001 will be lower-than-anticipated capital expenditures and pre-publication expenses, as well as a $29 million tax refund related to SAB 101 restatements.

Now, let's focus on some key numbers for the quarter.

Pre-publication spending, our biggest single investment, totaled $72.8 million for the third quarter, up 23.4% from a year ago. For the three quarters, pre-publication costs increased 15.3% to $188.4 million. These costs will be approximately $300 million by the end of the year, slightly below our earlier estimates, but still reflecting support of strong adoption opportunities, as well as the presence of The Tribune, Mayfield, and Frank Schaffer operations.

Capital expenditures were $28.8 million in the third quarter, $10.3 million above a year ago. For the three quarters, capital expenditures grew by 31.6% to $69.9 million, and will reach $135-to-$140 million at year-end, about $10 million below our initial projections.

Corporate expenses are $53.8 million for the nine months, 16.5% below the same period last year. In the third quarter these expenses totaled $20.3 million, down 17% from a year ago. We anticipate that these expenses will grow at about the rate of inflation in the fourth quarter. A smaller incentive compensation program in 2001 and a one-time gain on a real estate sale mainly explain the reduction in corporate expenses during the year.

Let’s now look to our non-cash items.

Amortization of pre-publication costs was $107.7 million for the third quarter and $197.3 million year-to-date, $9.6 million and $26.6 million higher than a year ago, respectively. As we projected early this year, we will end 2001 near $250 million, as we keep growing our investments in the education market.

Depreciation fell by roughly 1% in the third quarter to $20.3 million, reaching $65.7 million in the three quarters, up 2.3% from last year. We will end 2001 in the $100 million range.

Amortization of goodwill and intangibles grew by 34.8% to $22.5 million in the last quarter and 47.5% to $67.2 million so far this year. The steep increase reflects the effects of Tribune Education so far during this year. We expect this expense to hit $85-to-$90 million by year-end. As you know, early in the third quarter we acquired CVC and FT Energy. The new FASB rules for goodwill amortization have eliminated our requirement to amortize the goodwill, and we will instead provide a periodic assessment of impairment for those acquisitions.

And, finally, let’s talk about some key financing items:

Our debt is on track. Since the beginning of the year debt has increased by $193.7 million to $1.2 billion, a level similar to a year ago, despite making over $300 million of acquisitions this year. Large seasonal collections will take place during the fourth quarter, and we will end 2001 with debt of about $1.1 billion, as projected early in the year.

At current debt levels, our long-term debt continues to be rated A1 by Moody’s and A+ by Fitch. Both rating firms assign their highest ratings to our short-term debt.

Interest expense is $46.5 million after nine months, up 30.4% from the same period a year ago. However, the steep decrease in interest rates will help us end the year with interest expense near the $60 million mark, a bit below our initial estimates.

Currently, our debt is essentially commercial paper, with a weighed yield of 3.11% that will tend to fall as we roll over. Rates for new commercial paper are currently averaging 2.4%.

Our stock repurchase policy remains unchanged, and we have been actively buying back stock during the year. In the third quarter we repurchased 650,000 shares at an average price of $60.12 per share, and a total of $39.1 million. For the nine months we have bought back 1.8 million shares at an average price of $63.38 per share, for a total of $114.7 million.

This is the third year since the Board of Directors authorized the purchase of up to 15.0 million shares, and we have since acquired 8.1 million shares. We bought 3.2 million shares in 1999 and another 3.1 million shares in 2000, for a total of $341.5 million.

We are in the market in the fourth quarter and still plan to achieve our goal of repurchasing over 3.0 million shares this year. So far in October, we have purchased more than 890,000 shares at an average price of $49.52, so our total for the year so far is about 2.7 million shares.

Thank you.

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995

Information in this presentation contains certain forward-looking statements about the company’s business, new products, sales, expenses, cash flows, and operating and capital requirements. Such forward-looking statements included, but are not limited to: McGraw-Hill Education’s level of success in adoptions and the level of educational funding; the strength of higher education, professional and international publishing markets; the strength of profit levels and the capital markets in the U.S. and abroad with respect to Standard & Poor's; the strength of the domestic and international advertising markets; the level of future cash flow, debt levels, capital expenditures and prepublication cost investment; the level of success in new product development; and the expected financial impact of the Tribune Education acquisition on the Company's financial condition.

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 on various important factors, including but not limited to: worldwide economic and political conditions, the health of capital and equity markets, currency and foreign exchange volatility, continued state and local funding for educational matters, expenditures for advertising, the successful marketing of new products, the effect of competitive products and pricing.