The McGraw-Hill Companies
2nd Quarter 2002 Earnings Conference Call

Prepared Remarks
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Thank you. And good morning and thank you everyone for joining us, both here at McGraw-Hill and on the conference call, for this morning's discussion of The McGraw-Hill Companies second quarter 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 second quarter 2002 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 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

Good morning and welcome to our review of second quarter earnings for The McGraw-Hill Companies.

After my review of operations, I will ask Bob Bahash, our chief financial officer, to look at some other important measures of our performance.

Earlier this morning, we reported second quarter earnings. We beat the First Call consensus by three cents. Our earnings per share were 70 cents, an 18.6% increase when you exclude a two-cent gain last year from one-time items. Both our results and the First Call consensus for the second quarter include a four-cent benefit from the discontinuation of goodwill amortization. Revenue grew by 3.6% to $1.19 billion. Our operating margin improved to 18.3%.

We are taking this opportunity to update our guidance. We are still on track for a double-digit gain in earnings. That means we're looking for a double-digit gain in the third quarter and a double-digit gain for the full year. We're using $1.22 for the third quarter and $2.45 for the year as the basis for our guidance and we're not including a five-cent benefit for the third quarter and a four-cent benefit in the fourth quarter from the discontinuation of goodwill amortization.

Financial Services

Now let's look at our segment performance. Let's start with Financial Services, which had another outstanding quarter.

Revenue increased by 13.9% and operating profit grew by 40.3%. The operating margin at 37% expanded by about 300 basis points over last year's second quarter.

The margin expanded in the quarter because:

- We kept a tight grip on costs here and abroad,
- Infrastructure costs overseas are growing more slowly now that the Financial Services' global network is firmly established,
- Divestitures last year and the shutdown of the *Blue List* made comparisons easier in 2002, and
- Since we price for value, the robust growth in the more complex structured finance market again contributed to operating margin expansion.

If you look at new issuance in the U.S. bond market, the second quarter is a repeat of the first quarter. Once again, a decline in corporate new issuance pulled down the total volume, which declined by 5.7%. For the first half, new issue volume is down 6.8%, but that figure disguises robust gains in both the first and second quarters in structured finance and public finance. For the first half, mortgage-backed dollar issuance is up 22.9%, asset-backed issues are up 13.0%, and public finance is up 18.8%. In Europe, bond issuance was down 17.4%, but our business showed strong growth.

Once again, the results at Standard & Poor's Credit Market Services illustrate that our mix of business can keep producing even when a significant part of the market is in a slump.

Structured finance today is a global business and we are benefiting from worldwide growth in asset-backed and mortgage-backed securities. Both domestic and overseas ratings grew at double-digit rates for the quarter with international operations actually growing faster than domestic.

More than 31% of our ratings revenue came from non-U.S. sources in the second quarter.

Public finance was also a strong contributor to our second quarter success. Low-interest rates and state municipal budget issues will keep the public finance market growing this year. For The McGraw-Hill Companies, the continued growth of the public finance market this year represents a real plus in our lineup for those who are concerned about state and local budgets, especially in the education area.

We expect continued robust growth in the structured finance market here and abroad. A further drop in interest rates could trigger still more growth in the issuance of Residential Mortgage-Backed Securities.

We're not counting on an upturn in the corporate market this year, but we expect opportunistic financing to continue in the second half, and this again could be an area of upside in the second half.

We expect more growth in our non-traditional services. For example, in the U.S. and Europe, we continue to see increased institutional participation in the Bank Loan rating market. In short, the outlook for ratings continues to be very strong.

In investment services, revenue declined in the second quarter as the retail brokerage, foreign exchange and Internet redistribution markets were all soft. But stringent cost control and growth in our higher margin businesses boosted profitability.

The index services business continues to grow. Assets under management based on S&P Indexes at the end of the second quarter reached $52.3 billion, a 32.4% increase over the same period a year ago.

With Credit Lyonnais actively promoting the growth of the exchange-traded fund based on the S&P Europe 350 index, we now have more assets under management than the ETFs based on either the FTSE or MSCI European indices.

We continue to introduce new indices and funds based on our indices. In June, S&P launched the S&P ADR Index with the assistance of J.P. Morgan. The index is designed to track the non-U.S. portion of the S&P Global 1200 with U.S.-listed securities, primarily ADRs in New York. A new exchange-traded fund in Australia marks the first sector ETF in the Asia-Pacific region. We were in Hong Kong last week where we signed an agreement with the Hong Kong Stock Exchange. S&P will work with the Hong Kong Exchange to create four co-branded indexes. There will be a large cap, a mid cap, a small cap, and a composite of all three. They will be known as the S&P/HK Ex indexes. They will become available real time in October. It promotes benchmarks, it promotes new investment vehicles, it promotes simpler access to the region, and it promotes transparency. You will see more activity as the year unfolds.

We're also expanding at Corporate Value Consulting. In a strategic expansion, CVC this summer will be adding 10 managing directors and 41 directors, managers, senior associates and others from Arthur Andersen. The additions enable CVC to expand its national coverage, strengthen corporate finance consulting, tax and financial reporting operations and enter the real estate valuations market with the scale required to be a player in this segment.

Let me be clear. We have not purchased any assets from Arthur Andersen. Instead, through a careful screening process, CVC senior management has recruited some seasoned and talented executives who will effectively contribute to our organization's growth.

With revenue of $42.5 million in the first half, CVC is off to a somewhat slower than expected start largely due to the slower M&A activity, but we're on the right path and very excited about our prospects here.

So, let's sum up for Financial Services:

- Continued strong growth in ratings here and overseas,
- Structured finance and public debt markets will lead the way,
- Expansion at Corporate Value Consulting,
- Double-digit top and bottom line growth for 2002, and
- Expanding margins.

McGraw-Hill Education

Now, let's look at McGraw-Hill Education. Revenue increased 1.9% and operating profits declined by 5.8%.

There are two major units in McGraw-Hill Education: the Higher Education, Professional and International Group and the School Education Group. Our Higher Ed group's revenue is up 10.9% for the second quarter to $170.5 million. Our School group's revenue was off 1.4% to $406.5 million.

Clearly, our college and university business is off to a fine start and we expect to continue double-digit growth in this market. We attribute our success in the higher education market to the way we are combining texts and technology. Our digital solutions provide an interactive way for students to study, course management systems for instructors, and online assessments. The result is a better package for instructors and students.

Our professional markets benefited from the publication of a new edition of our *Encyclopedia of Science and Technology*. This 22-volume work is now in its ninth edition. We've also added an important new module to our growing Access Medicine website. The *Metabolic and Molecular Bases of Inherited Diseases* has been the leading text in the field for more than 40 years. It is the core of a new offering on the Web with the promise of continually updated information so the subscriber can keep pace with the major strides being made in genetic research.

It's the latest example of how we continue to use core texts to create subscription-based services that, in this case, offers researchers and physicians what is essentially a new global knowledge product with seven new sections on cancer and fresh data on counseling and therapies for inherited diseases.

In our international markets in this quarter, solid secondary school sales in Mexico and a good performance in Canada were key drivers.

Now, let's look at our School Education Group. There are always questions at this time of year about the outlook for the elementary-high school market, but this year there seems to be even more questions than usual.

As we see it, there are really four key questions:

1. What is the impact of state funding on the education market?
2. Will new federal funds from the *No Child Left Behind Act* add incremental dollars to the market this year?
3. How much will the el-hi industry grow in 2002?
4. How will McGraw-Hill School Education Group perform in this environment?

Let's look at each of these questions and provide some answers based on what we know today.

State funding for education has been a concern for some time. 46 states each spring work on new budgets for a fiscal year that starts on July 1. For 40 of these states, budgeting for the new fiscal year became more complicated because tax receipts were coming in below forecasts. Only six states reported that tax revenue beat their forecast for the January-April period this year. Another complication is that some key states, like California, did not complete their budget deliberations by July 1.

So there are still questions marks out there. But we do know that recent polls show education remains a top priority for the American public, particularly when it concerns instruction. That's why education is one of the few areas state legislators resist cutting. When reductions are made, they usually occur in new or peripheral programs, before and after school programs, in summer school and in administration. Protecting instruction is the goal.

Many states and municipalities are using new so-called "sin" taxes on tobacco or gambling, tapping contingency funds, or even raising tax rates to avoid major cuts in educational spending.

The only major instructional cut we know about at this time may occur in California where the revised budget currently provides $50 million less than the $523 million originally proposed. The lower amount still represents an 11.8% increase over the previous year.

- In Florida, the educational budget for instructional materials in fiscal 2003 has been increased by 6.7% over last year.
- In New York, the fiscal 2003 budget for education will increase less than 1% over fiscal 2002.
- Illinois is reducing el-hi funding by 1.3%, a $70 million cut from what is actually spent in the previous fiscal year. The cut is coming in grants and not in basic funding.

At this point, we still don't have all the facts on how much states will spend on educational materials in the new fiscal year.

The National Conference of State Legislatures yesterday reported that 40 states have budgeted a 4.8% increase in K-12 education for the fiscal year starting in July. That includes 11 states that are planning cuts in K-12 education. Overall, total spending, not just for education, in the 40 states we know about is budgeted to grow 1.6% for the new fiscal year. Based on what we are hearing, it seems fair to conclude that overall state spending on educational materials in the new fiscal year is still under pressure but is showing more promise than some people thought.

The second question is about how fast federal dollars from the new *No Child Left Behind Act* will flow into the market this year. We've been watching this situation carefully. Right now, it looks as if the lion's share of the authorized funding will be spent at the state and local level next year even though the money is starting to flow now.

On June 25th, the Department of Education made the initial *Reading First* grants under the HR1 program. Let me give you some of the details:

- Alabama will receive $15.5 million this year and $102 million over the next six years.
- Florida was granted $45.6 million this year and nearly $300 million over six years.
- Colorado gets $9 million for the first year and $89 million over a six-year period.
- We know that 26 states, the District of Columbia, and Samoa have already applied for funding so more announcements about grants should be made throughout the summer.

But when you examine the programs submitted by the states that have already received funding, it is clear that the first big wave of spending won't occur until next year.

- Florida says it won't implement *Reading First* until next January because educators need time to plan and train for the introduction of the new programs at the start of a new school year.
- Colorado plans to give $7.2 million in grants to 45 schools in the spring of 2003.
- Alabama will make sub-grants of $12.5 million to 60 schools as early as December. Alabama officials also say that up to 80% of the total grant money will go directly to schools meeting *Reading First* eligibility requirements. To receive a grant, each Alabama school must employ a reading coach, use research-based reading programs, use specific assessments, and spend $1,000 for every teacher in the school for professional development. Training started this month.

Given the pressure on state and local education budgets and the latest information on the timing of new federal money, it now appears that the el-hi market this year will not reach the high end of our earlier 0-4% growth projections.

We knew that the adoption market this year would not match last year's. The big question, then, is the performance of the open territories in the third quarter. This is a difficult area to call and never more so than this year. Funding allocations in the open territories generally occur at the local level, making them more difficult to quantify and to predict. And this year many schools delayed decisions as they waited for guidance on *Reading First* requirements from their state and local education agencies. That means we will not have a clear picture of open territory spending until well into the third quarter. The industry needs a solid performance in the open territories to stay on a growth plan for this year. Softness in the open territories will reduce or even create a downturn in el-hi market sales for the year.

Even in this environment, we expect to maintain our share this year. Our third quarter adoption sales are generally in line with our previous expectations. We still expect to capture about 30% of the adoption market this year. Early signs in the open territories are very encouraging, but there are too many uncertainties to predict the outcome right now.

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

- Another year of growth in this segment,
- Strength in higher education, testing, supplementary reading and math and secondary school markets will keep us moving ahead in 2002,
- We're still on track to achieve a 15% operating margin in this segment, and building from there.

Information and Media Services

Now let's look at Information and Media Services. Revenue declined 9.1% and operating profits were off 19.7%.

We've reduced costs by 7.2% for the quarter to shield some of the decline. In fact, operating costs for the segment are down $20.9 million for the first half, so this management team has worked very effectively to

hold the line under difficult circumstances. With costs tied down so tightly, we've substantially improved our leverage and any improvement in advertising is going to show up on the bottom line.

Our situation is starting to look better. *BusinessWeek* ad pages were off 33.4% in the first quarter and 20.4% in the second quarter. But *BusinessWeek* is starting the third quarter on a positive note. After the five issues in July, *BusinessWeek* ad pages are up 4.6%, according to the Publishers Information Bureau. The battle is won a week at a time, but we want to see a pickup in capital spending and continued business spending activity so we know the pickup is sustainable.

Of course, we are also benefiting from easier comparisons. In the third quarter last year, *BusinessWeek* ran 772 advertising pages, a drop of 40% versus the same period in 2000. *BusinessWeek* experienced another 40% drop in the fourth quarter of last year following the terrorist attack of Sept. 11th.

The ad picture is also brightening in our Broadcasting operations. For the first time this year, Broadcasting has a positive pacing at the start of the quarter. Right now, the Broadcasting Group's pacing is up mid-single digits for the third quarter.

The Aviation Week markets faced tough comparisons in the second quarter because the Paris Air Show was held at that time last year. This year, we're looking forward to the Farnborough Air Show in Great Britain in the third quarter.

In the energy markets, Platts, our global energy brand, continues to benefit from the acquisition of FT Energy.

And in the construction market, tight expense control allows us to have increased operating profitability.

Summing up for the Information and Media Services Group:

- Tight expense controls will improve our leverage and advertising revenue will be able to drop to the bottom line.
- Signs of positive improvement in advertising.

There you have the current picture for the Corporation.

So, let's sum up:

- Continued strength in Financial Services and margin expansion,
- A double-digit gain in higher education will help offset slower than expected growth in the el-hi market,
- Improving prospects in advertising,
- Continued emphasis on cost and expenses, and
- A double-digit increase in earnings-per-share in the third quarter and for the full year.

Simply stated, we're on target.

Now, I'd like Bob Bahash, our CFO, to give you some additional performance indicators.

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

Thank you, Terry.

The Corporation continues to maintain a strong financial position.

We completed the first half with our debt at $1,163 million. That's $133 million lower than it was for the same period last year, but $107 million higher than it was at year-end. Our debt level reflects the usual seasonal ramp up in borrowing because of our investments in the education market.

Virtually all of our debt is in regular commercial paper at favorable rates. The average interest rate on commercial paper borrowing has declined from 5.6% last year to 1.9% this year. At the end of June, our outstanding commercial paper had a weighted average maturity of 62 days.

We continue to benefit from lower interest costs. Interest expenses were down 55.4% for the second quarter and 58.7% for the first half. We paid $13.6 million this year in the first half versus $32.9 million last year. Given the low interest rate environment and debt levels that have already peaked this year, we expect favorable comparisons for the remainder of the year.

As part of a worldwide restructuring program announced last fall, we planned a workforce reduction of 925 positions. At the end of the first quarter, 348 had been terminated. For the first half, the figure has grown to 773. We expect to complete this program by the end of the year.

In the restructuring, we were closing our business training courseware operations. In June, we sold selected courseware, technology and e-learning assets from this unit to the Thomson Corporation. We also divested a unit of McGraw-Hill Construction in June. CAP, a space planning and specification software company for the contract office furniture industry, was sold to 20-20 Technologies. CAP was headquartered in Grand Rapids, Michigan.

Cost containment measures are always important, so it is worth noting that our costs and expenses for the first half are virtually flat. Lower manufacturing costs played a key role in our ongoing containment efforts. Last year, combined printing, paper and distribution expenses accounted for 23% of our operating expenses. Through various actions, we expected a 3.0% decrease in these expenses this year. But recent successful negotiations with suppliers have enabled us to roll back printing and paper costs some more. As a result, we now expect to reduce manufacturing expenses by 3.8% this year.

Let's look at some other costs.

Pre-publication costs still represent our biggest, single investment each year. We spent $80.0 million in the second quarter and $114.9 million for the first half. We are still expecting to spend about $300 million for the year.

Our capital expenditures for the second quarter came in at $17.5 million and stand at $26.9 million for the first half, down 34.6% from last year. We expect to end the year substantially under last year's total of $116.9 million.

I also want to point out a new line in the cash flow statement for technology projects. For the first half, we spent $33.8 million on these technology projects. A deferred project requires development to make it productive, which is why we don't include them as capital expenditure items.

The new Global Transformation Project for McGraw-Hill Education is a major undertaking and accounts for most of the dollars in this category. To simplify our business processes for the entire McGraw-Hill Education Group, we are reengineering our systems for customer services, production, inventory, and data management. Working with Oracle and Accenture, we are successfully piloting this project in Canada. On June 3, we went live. We successfully closed the second quarter books for the first time in Canada using the Oracle 11i software.

The roll out to U.S. divisions will start next year, followed by international locations. A substantial share of the investment in the Global Transformation Project has been made in the last 18 months. These projects are amortized as they come online.

Depreciation for the second quarter was $23.4 million and $47.0 million for the first half, an increase of 3.7%.

Amortization of pre-publication costs was $71.7 million for the second quarter and $104.8 million for the first half, an increase of 16.9%. We expect to hit $300 million this year.

Amortization of goodwill and intangibles, because of FAS 142, declined 58.2% to $9.8 million in the second quarter and $19.7 million for the first half, a 55.8% decline. For the year, we expect, basically amortization and intangibles, to report about $38 million.

Starting in the second quarter, we began to repurchase shares. So far this year, we have bought back 965,000 shares. We plan to repurchase between 3.0 million and 3.5 million this year.

Thank you.

Safe Harbor Statement under the Private Securities Litigation Reform Act of 1995
This document includes certain forward-looking statements about the Company's business, new products, sales, expenses, cash flows, spending, and operating and capital requirements. Such forward-looking statements include, but are not limited to: Educational Publishing's level of success in 2002 adoptions and non-adoptions; the level of educational funding; the strength of higher education, professional and international publishing markets; the level of interest rates and the strength of profit levels and the capital markets in the U.S. and abroad with respect to Standard & Poor's Credit Market Services; the strength of the domestic and international advertising markets; Broadcasting's level of advertising; and the level of future cash flow, debt levels, capital and other 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, the successful marketing of new products, and the effect of competitive products and pricing.