The McGraw-Hill Companies

The McGraw-Hill Companies
1st Quarter 2007 Earnings Conference Call

Prepared Remarks
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The McGraw-Hill Companies

Thank you and good morning. And thank you everyone for joining us today for The McGraw-Hill Companies' first quarter 2007 earnings conference call. I am Donald Rubin, Senior Vice President of Investor Relations at 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 2007 results. We trust you have all had a chance to review the release. If you need a copy of it and the financial schedules, they can be downloaded at www.mcgraw-hill.com/investor_relations.

Before we begin this morning, 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 Form 10-Ks, 10-Qs, and other periodic reports filed with the U.S. Securities and Exchange Commission.

We are also 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 Mr. Steve Weiss in our New York office at (212) 512-2247 subsequent to this call. Today's update will last approximately an hour. After the presentation, we will open the meeting to questions and answers.

Now it is my pleasure to introduce the Chairman, President and CEO of The McGraw-Hill Companies, Harold McGraw III.

Terry.

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

Good morning, everyone. And welcome to our review of The McGraw-Hill Companies' first quarter results. Joining me today is Bob Bahash, Executive Vice President and Chief Financial Officer. We will begin by discussing our results in the first quarter and the outlook for the rest of the year. Bob will then review our financial performance. And, as always, we'll go in any direction after that that anybody would like to go.

Earlier this morning, we announced our first quarter results. We reported:

- Earnings per share of $0.40, including a $0.03 gain on the sale of a mutual fund data business in March.
- Revenue grew by 13.7% to $1.3 billion.
- Margin improvement in all three segments.

Historically, the first quarter is the smallest each year, but clearly we are off to a very good start to achieving our goal of producing double-digit earnings growth in 2007. As we look ahead, we see that:

- Inflation is under control at 2.5%.
- The U.S. gross domestic product is growing at 2.4%.
- The unemployment rate is holding at about 4.4%.

All in all, a pretty good situation.

David Wyss, the Chief Economist at Standard & Poor's, was looking for a Fed rate going down probably by midyear. He now thinks it is closer to the end of the year, but that the next move still will be down. David believes that housing starts and sales are bottoming out after a 30% decline.

- Housing prices are down 3% and will probably decline another 5% between now and the end of the year.
- Non-commercial construction is doing very well.
- State revenues are solid.
- Bond rates are stable.
- The Federal Reserve has held the funds rate at 5.25% since last June and no change is expected soon. One cut to 5% is possible by the end of the year.

With that as background, let's review our operating results.

McGraw-Hill Education

Let's begin with McGraw-Hill Education. We expect education to be an important contributor to our performance in 2007. We are encouraged by the start this year, even in a seasonally slow quarter.

- Revenue increased 5.6%.
- The operating loss was reduced by 6.6%.
- Cost and expenses are under tight control and rose by only about 2.7%.
- The Higher Education, Professional and International Group revenue grew by 11.5% to $186.9 million and contributed 56% of the segment's first quarter revenue.
- School Education Group revenue was off 1.2% to $144.8 million.

Let's take a closer look at the results.

In the K–12 instructional market, the first quarter represents, as we all know, less than 10% of the full year. Sales in this period tend to consist largely of residual or supplemental orders plus some early new adoptions, which may arrive toward the end of March. The pattern was skewed in the first quarter last year because we booked $9 million in late orders from Texas for music, health and some online programs. Obviously this did not repeat in 2007.

We closed most of the gap. A key driver was March orders from North Carolina for our K–5 music program and vocational, family and consumer science programs for grades 6–12. More important are the early indicators that our newly-integrated school team is performing very effectively and that the strength we expected in the state new adoption market is starting to materialize.

These trends take on added importance this year because we have stepped up our participation in a growing state new adoption market. In 2006, we participated in only 80% of the state new adoption market. This year, we have products for virtually the entire state new adoption market, which we expect to grow 10 to 15% or to between $750 and $800 million. As this chart shows, we believe the state new adoption market is poised for growth for the rest of the decade.

It is much too soon to make predictions on our results this year. Sales campaigns are running at full throttle. But I can report that we are very pleased with the early feedback.

Science in California and South Carolina; math in Texas and New Mexico; and music in North Carolina all look very promising at this time.

We are also encouraged by the early showing of our middle school products in the second year of the California social studies adoption. Solid opportunities are taking shape in some large urban markets, including New York City, Boston, Milwaukee, and Washington, D.C. We've already realized some substantial sales in Washington, D.C. for K–5 science and 6–12 social studies.

We're optimistic about our opportunities in the open territory. We are competing with new products in K–5 science, 6–12 literature, and new editions of *Everyday Mathematics* and *Open Court Reading*. We are also pleased with the early showing of a new supplemental product called *Science Snapshots*. Science poses its own special challenge to elementary school teachers, who typically are trained as reading specialists. Today, these teachers must help students learn the concept and language of science so they can score well on the new high-stakes tests. As mandated by No Child Left Behind, science tests start this academic year in elementary, middle and high school.

Preparing students for those tests is not a simple matter when you realize that complex concepts like photosynthesis are introduced into the curriculum as early as the third grade. To provide a classroom solution, we combined video, DVDs, and print to create a new program called *Science Snapshots* for use in the third, fourth, and fifth grades. The program includes 15 hours of video so students will have a familiar way to see and hear as well as read about science. And once again, we provide materials students can use to work independently on the computer. We believe that creating materials that address multiple learning styles of today's students is the route to success in the classroom and the marketplace.

In the testing market, we benefited from increases in custom work for state-wide assessment programs in Georgia, Colorado, Indiana, and Florida. Sales of off-the-shelf test products were flat in the first quarter.

As I pointed out earlier, we had double-digit growth in the first quarter at the Higher Education, Professional and International Group. We are quite pleased. In U.S. higher education, there is a phenomenon we call the “echo effect” — second semester ordering late in the year that echoes your success in the peak third quarter. When that second semester business arrives is not entirely predictable. Some years, it shows up in December. In other years, it can show in January.

Our higher education group heard the echo in January. We had a very strong January and that contributed to the solid growth we experienced with higher education products around the world in the first quarter. As you may know, we have three major imprints in this market:

- Science, Engineering and Mathematics;
- Business and Economics; and
- Humanities, Social Sciences and Languages.

All three produced solid gains in the first quarter.

We are seeing increased demand for our digital *Homework Manager* products, particularly in world languages, accounting, math, and economics. Our new online courses are getting a favorable initial response in the market. Using technology to create new products and incremental revenue is a key strategy.

We also are making real headway in professional markets where we have launched a number of new online products. Last July, we introduced *Harrison’s Practice*, which marked our entrance into the emerging patient care market. *Harrison’s Practice* combines content from the Harrison’s editorial team — experts in the field of internal medicine — with an easy-to-use interface on a mobile platform, which makes it a true workflow tool for physicians in an ambulance, in an emergency room or in a doctor’s office.

Last week, we launched *Access Pharmacy*, an online product designed to keep pace with the changing demands of pharmaceutical education. This is a growing market. It is estimated that in five years nearly 300,000 practicing pharmacists will be needed to serve our aging population. That’s a 30% increase compared to 2002, according to statistics from the Department of Labor. For *Access Pharmacy*, we are leveraging the content of some of our classic reference texts, including Goodman & Gilman’s The *Pharmacological Basis of Therapeutics*. *Access Pharmacy* also offers a fully-integrated drug database in English and Spanish—all Web-based. Access Pharmacy joins *Access Surgery* and *Access Emergency Medicine* in our lineup of ready-access resources for medical professionals.

More digital products for major medical specialties are on the drawing board.

Let’s sum up the outlook for Education. In the el-hi market, we expect:

- 10 to 15% growth for the state new adoption market;
- 3 to 4% growth in the open territory; and
- Industry growth of 5 to 7%.
- Based on our new products and greater market participation in 2007, we expect to outperform the industry.

In the U.S. college and university market, we expect:

- Growth of about 4%.
- Based on our plans, we also expect to outperform this market.

We expect margin expansion for the segment in 2007.

One final point about the education market. The competitive landscape is changing. Some are exiting. New players are arriving. We have our plans in place to take advantage of growing global opportunities and the increased enrollments in the years ahead. It is clear to us that you can't sustain a knowledge economy without knowledge workers. That's why education today more than ever before is a necessity for our world and a growing opportunity for our team of professionals who know this market so very well.

Financial Services

Let's now turn to Financial Services.

By virtually any measure, Financial Services had an exceptional first quarter.
- Revenue increased 21.5%.
- Operating profit was up 38.3%.
- The operating margin expanded to 47.7%. That includes a $17.3 million pre-tax gain on the sale of the mutual fund data business in March.

There were many contributors to this outstanding performance:
- World liquidity is extremely plentiful.
- We continue to operate in a favorable interest rate environment.
- Spreads remain tight.
- Investor demand for fixed income instruments is strong.

Our diversified portfolio fired on all cylinders:
- Both our domestic and international rating revenue grew at double-digit rates with international outpacing the U.S. performance.
- Corporate and government ratings were strong.
- Structured finance was robust again globally.
- Products and services such as bank loan ratings that are not tied to the public new issue market grew substantially.
- Data and information products grew rapidly.
- Index services continued to expand.

We expected double-digit growth on the top- and bottom-line this year in Financial Services even though we forecasted a 10 to 15% decline in the issuance of U.S. residential mortgage-backed securities.

Clearly, we have gotten off to a very strong start in 2007.

Let me be clear: there will be more double-digit growth and margin expansion throughout the balance of the year in Financial Services, although probably not at the exceptional rate of growth that we enjoyed in the first quarter, but still very solid double-digit growth.

Let's look at this situation in more detail.

Corporate issuance in the U.S. set a record in the first quarter. It was up 43% to $336 billion. Both investment-grade and high-yield markets were strong performers. Strong merger and acquisition activity and a favorable financing environment are making this possible.

The demand for corporates continues unabated this year. Insurance companies and pension funds have been consistent buyers, snapping up bonds as five- and ten-year maturities in their portfolios are coming to term. The high-yield market is benefiting from the reduction in the default rate, which has dipped below 2% for the first time since 1997. Innovation in derivative markets is also attracting a growing number of new high-yield investors, such as hedge funds, to participate in this market.

Corporate fundamentals remain sound and we look for continued growth both here and abroad in this important market.

Public finance benefited from a pick up in refundings and new money issuance. The environment is favorable. There is an expanding group of buyers and an increase in asset allocations to higher quality investments by aging baby boomers. We expect a good year in public finance, although refunding volume is expected to moderate somewhat.

Structured finance produced another strong quarter despite a 10.8% decline in U.S. residential mortgage-backed securities issuance. As I pointed out earlier, we anticipated a 10 to 15% decline in U.S. residential mortgage-backed securities issuance this year. A slowing housing sector, rising mortgage rates, slower housing price appreciation, and fewer housing starts were factors in shaping our forecast.

As part of its ongoing ratings and surveillance process for residential mortgage-backed securities, S&P carefully monitors trends in the housing and mortgage finance market, consumer credit, and in the economy overall. Last spring, a little over a year ago, S&P foresaw the trend in the quality of mortgage lending that led to the concerns that have arisen in the sub-prime market today. As a result of the deteriorating credit quality of certain sub-prime mortgage loans in 2006, S&P increased the credit support necessary for a rating by 50% compared to transactions from 2005.

While there is a lot going on in the sub-prime market, nothing has occurred so far this year to cause us to materially change our expectations on the level of issuance we originally anticipated for 2007. It is also worth pointing out that the U.S. residential mortgage-backed securities market has not come to a dead stop in 2007 — not with $254.1 billion in issuance in the first quarter. Prime and Alt-A issuance increased 5.6%, partially offsetting the 24.4% decline in sub-prime issuance in the first quarter.

In Europe, residential mortgage-backed securities had a very strong quarter and the outlook is positive. Stable economic conditions combined with moderate home price growth in most European countries continue to fuel demand for mortgage credit. We also anticipate some residential mortgage-backed securities activity in emerging markets, including Russia and South Africa. And we started the second quarter with a very good pipeline.

In the commercial mortgage-backed securities market, issuance was also strong. In the first quarter, we saw steady improvement in Europe. Drivers of U.S. commercial mortgage-backed securities include strong commercial real estate fundamentals, historically low interest rates, the refinancing of maturing deals, and rising property values. And the pipeline looks very good.

In the U.S. asset-backed securities market, credit card and student loan activity offset the slump in auto loan asset-backed securities issuance. Credit card and student loans should keep this market growing. Growth in the European asset-backed securities market was driven by small business loans, auto loans and leases, and equipment leases. The outlook in Europe is also solid. Basel II should have a positive influence on the market as consumer banks restructure the risk on their balance sheets to adjust capital adequacy ratios.

We also saw robust growth in the U.S. and European collateralized debt obligation markets. In the U.S., collateralized debt obligations issuance, or CDOs, was up 154% in the first quarter. Our expectation coming into the year was that the growth rate in CDO issuance would slow from the torrid pace we saw in 2006. While the first quarter was strong, we expect the growth rate to slow in subsequent quarters and that assumption is already baked into our expectations.

Key factors in the U.S CDO market in the first quarter were concerns about widening spreads resulting from credit quality deterioration in the sub-prime market and an increase in collateralized loan obligations resulting from strength in the corporate loan market.

Although spreads did widen in the first quarter due to sub-prime issuance, they have tightened a bit since the end of the quarter. There is a general agreement that spreads may not change or, if they do, they could widen slightly during the remainder of the year. Our current estimates for the CDO market are based on such a scenario. S&P does not expect dramatic widening of spreads unless there is a shock of some sort to the system triggering some dramatic deterioration that we don't have baked in.

U.S. CDOs will continue to benefit from strong investor demand and broader acceptance of structures such as collateralized debt obligations of commercial real estate. There is constant innovation taking place in the CDO space with respect to structures and use of underlying collateral. This is not limited to the U.S. by any means and we will also see more growth in Europe.

S&P produced significant gains in products and services that are not directly linked to public debt issuance. These services, which accounted for 26.3% of ratings revenue in the first quarter, are another important measure of the diversity we have created in the S&P portfolio. Bank loan ratings were a key driver of this growth. We anticipate more growth this year from bank loan ratings, counterparty credit ratings, financial strength ratings, derivatives, and risk services.

S&P also benefited from solid growth of its products and services for equity markets. The Capital IQ product continues to grow rapidly and now has more than 1,900 clients. We have also increased the number of subscribers here and abroad for some of our other information products — Ratings Direct, Ratings Xpress, and Compustat Xpressfeed.

We continue to expand our index services. At the end of the first quarter, there were 113 exchange-traded funds linked to S&P indices — 85 in the U.S. and 28 outside the U.S. Our S&P/Citigroup indices form the backbone of a new, fast-growing business for benchmark indices, index data, and custom indices. At the end of March, assets under management in exchange-traded funds based on S&P indices increased 23.7% to $170.3 billion.

We also benefited in the first quarter from the increased trading of derivative contracts based on S&P indices, especially the E-mini which is traded on the Chicago Mercantile Exchange. Average daily volume for E-mini contracts in the first quarter was 1,376,979.

So summing up our Financial Services, more double-digit growth and margin expansion for the balance of the year, although probably not at the exceptional rate of growth produced in the first quarter.

Information & Media

Let's now go over the Information & Media segment.

- Revenue increased 4.1%.
- Operating profit was $9.9 million, up from $1.7 million for the same period last year.
- The operating margin improved to 4.2%.

An important factor was the transformation of Sweets last year from primarily a print catalog to a bundled print and online service for the construction industry. Because of the change, Sweets' revenue is now earned throughout the year. As a result of this change, Sweets contributed $6.5 million in revenue and $5.8 million in operating profit to this segment in the first quarter.

Revenue for the Business-to-Business Group grew by 7.5% in the first quarter to $212.3 million. This group includes some of our best-known brands — *BusinessWeek*, J.D. Power and Associates, Platts, McGraw-Hill Construction and Aviation Week. The Sweets transformation and growth in Platts' real-time news services for oil, natural gas, and power markets were key contributors.

Ad pages in *BusinessWeek's* global edition were off 3.0% in the first quarter.

Broadcasting's revenue fell 18.8% in the first quarter. There were three major influences in the first quarter:

- The absence of political advertising.
- The loss of the Super Bowl.
- The decision not to renew the *Oprah Winfrey Show* in two markets.

Pacing for the second quarter is off about 14%.

This segment is in transition. We have pointed out before that the Internet is reshaping the business-to-business market and we are working hard to add value to our audience. We are making progress in the new digital world. I've already cited the transformation of Sweets in the construction market.

In the energy market, traders are looking for better tools to help them work with real-time information. Earlier this month, we took an important new step to increase the efficiency and transparency of physical oil markets. Platts' eWindow is a new online tool using leading edge technology to significantly improve our service to traders who use our daily price assessments as benchmarks in the oil market. This is a solution with real promise. Benchmark prices are increasingly used as the basis for industry contracts, financial risk management, and for cash settlement of futures contracts traded at commodity exchanges literally around the world.

With globalization and technology making markets more dynamic than ever before, the need for reliable, transparent benchmarks and other critical news and analysis of such strategic commodities like oil and steel are helping to drive growth in our real-time subscription services.

We are also expanding by licensing our intellectual property for use in broader financial and futures markets. The most recent example is last week's announcement by the Intercontinental Exchange that it has selected one of our benchmarks, Platts' Dubai price assessment, as the basis for cash settlements on a new crude oil futures contract.

BusinessWeek.com continues to improve its performance with increases in advertising and unique visitors compared to last year. We continue to make investments in this product.

Building communities is an important aspect of our new digital world. That's why *Architectural Record*.com now makes it possible for architects to post their work on its website. The site includes blogs and a rating system that encourages readers to participate by evaluating the projects that appear online and in the publication. Our objective is to make it easy for readers to share their work and interact with their peers and with our editors. Not bad for a 116-year-old publication.

Let's sum up for Information & Media:

- A soft start in advertising, particularly at Broadcasting in a non-political year.
- Growth in online services.
- Margin expansion.

That completes our review of operations, so let's sum up for the corporation:

- Some encouraging indications in Education.
- A strong start in Financial Services.
- Progress in Information & Media.
- Margin expansion in all three segments.

Our guidance for 2007: Double-digit earnings growth in 2007.

Let me now turn it over to Bob Bahash, our Chief Financial Officer.

Robert J. Bahash
Executive Vice President and Chief Financial Officer
The McGraw-Hill Companies

Thank you Terry.

We mentioned during our January conference call that we intended to purchase 15 million shares in 2007 under the share repurchase program approved by the Board of Directors in January 2006. We elected to accelerate our program and purchased 13.2 million shares during the first quarter on a trade-date basis at a total cost of $842.4 million. We expect to purchase the remaining 1.8 million shares during the remainder of 2007. Of the $842.4 million total amount, approximately $231 million was settled and funded at the beginning of the second quarter.

There are now remaining 6.8 million shares that are available to be purchased under the 2006 buyback program. Earlier this year, the Board provided additional flexibility by authorizing a new buyback program of 45 million shares.

Since 1996, the Corporation has returned $6.8 billion to shareholders through dividend payments and share buybacks, including approximately $915 million returned to shareholders in the first quarter of 2007.

The diluted weighted average shares outstanding, or WASO, for the first quarter of 2007 is 361.5 million shares, a 15.8 million share decrease compared to the first quarter of 2006 and a 2.7 million share decrease compared to 4Q 2006. The quarter only benefited modestly from the first quarter buyback of 13.2 million shares since the bulk of the repurchases occurred near the end of the quarter.

We have resumed borrowing in the commercial paper market to fund our seasonal cash requirements and ended the first quarter in a net debt position of approximately $178 million. This compares to a net cash position of $351 million at year-end 2006. As of March 31, on a gross basis, our debt position is $607.5 million offset by $429.6 million in cash, primarily foreign holdings. We expect to return to a net surplus cash position by the end of the year.

Interest expense was $1.2 million in the first quarter. Last year we were essentially debt free in the first quarter and had net interest income of $2.5 million. Interest expense for the second quarter will increase since it will reflect commercial paper borrowings for the full quarter.

For 2007, we now expect the full-year interest expense to range between $24 to $26 million. This is higher than our previous estimate due to the timing of funding costs related to the accelerated share repurchases as well as additional interest expense resulting from the implementation of FIN 48. “FIN 48”, or FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes,” became effective for the Company on January 1, 2007. GAAP-based financial statements must account for taxes, including an analysis of all tax positions. FIN 48 clarifies the accounting treatment of uncertain tax positions taken or expected to be taken in income tax returns. FIN 48 also clarifies the rules regarding accruing interest on uncertain tax positions. We will continue to accrue within the interest expense category.

Last year we transformed Sweets, McGraw-Hill Construction Group’s popular building products database, from a primarily print catalog to a bundled print-and-online service. The associated accounting change benefited year-over-year comparisons for Information & Media. First quarter 2007 results reflect $6.5 million of revenue and $5.8 million of operating profit resulting from the Sweets transformation.

Let’s now look at our corporate expenses. Corporate expenses decreased $5.6 million, or 13.8%, in the first quarter compared to a year ago, but there were several one-time factors that influenced this decline. Last year’s first quarter corporate expenses included a $14.8 million charge relating to the elimination of the restoration stock option program. The year-over-year comparisons are also impacted by a $4.6 million gain on the sale of the Dubuque, Iowa office and printing facility in 1Q 2006.

Categories within corporate expense that increased are the following:

- Expenses associated with the new Business Process Management program implemented this year to strengthen our core processes and ensure alignment with customer needs while improving operational efficiency;
- An increase in vacant space from downsizing and business rationalization initiatives implemented in 2006; and
- Higher incentive compensation.

The effective tax rate in the first quarter was 37.7%. The 50 basis point increase from the prior year is driven by the change to the accounting for uncertain tax positions (FIN 48), the gain in connection with the sale of the Company’s mutual fund data business, and a state tax audit settlement. Based on these factors, the operating effective tax rate for the balance of the year is projected to be 37.5%.

Now let's take a look now at capital expenditures, which include prepublication investments and purchases of property and equipment.

In the first quarter our prepublication investments were $57.4 million compared to $61.6 million for the same period last year. For 2007, our prepublication investments will now be about $310 million. We anticipate a reduction in spending from our original projection of approximately $330 million through efficiencies, technology, global sourcing, and simply firming up our forecast for the year.

Purchases of property and equipment were $22.7 million in the first quarter compared to $11.6 million for the same period last year. This increase is due to the construction of our new data center—which has now begun—along with technology investments we are making to digitize our products and services. We continue to project $250 million for 2007.

Now for the non-cash items.

Amortization of prepublication costs was $28.1 million in the first quarter compared to about $22.5 million in the same period last year. We ramped up our publishing schedule last year in anticipation of the strong el-hi new state adoptions in 2007, 2008, and 2009. We continue to expect $260 million in amortization of prepublication costs for 2007.

Depreciation was $28.9 million in the first quarter compared to $27.6 million in the same period last year. We still expect it to be $130 million in 2007, reflecting the higher level of capital expenditures in 2007 and a full year of depreciation from capital expenditures made in 2006.

Amortization of intangibles was $11.6 million in the first quarter compared to $11.9 million in the same period last year—a slight decrease but basically flat. For 2007 we continue to expect $50 million.

Thank you.