The McGraw-Hill Companies

The McGraw-Hill Companies
2nd Quarter 2010 Earnings Conference Call

Prepared Remarks
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Thank you and good morning to our worldwide audience and thank everyone for joining us this morning at The McGraw-Hill Companies' second quarter 2010 earnings call. I am Donald Rubin, Senior Vice President of Investor Relations at The McGraw-Hill Companies.

With me this morning are Harold McGraw III, Chairman, President and CEO, and Robert Bahash, Executive Vice President and Chief Financial Officer.

This morning, the Company issued a news release with our second quarter 2010 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 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'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 Mr. Jason Feuchtwanger in our New York office at (212) 512-3151 subsequent to this call. Today's update will last approximately an hour. After our presentation, we will open the meeting to questions and answers.

It is now my pleasure to introduce the Chairman, President and CEO of The McGraw-Hill Companies, Terry McGraw.

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

Thank you very much, Don. Good morning everyone and welcome to our review of second quarter earnings and outlook for the year. With me today is Bob Bahash, Executive Vice President and Chief Financial Officer. I will review second quarter results and guidance. Bob will then provide an in-depth look at our financials. After the formal presentation, we will be pleased to answer any questions or take any comments you may have about The McGraw-Hill Companies.

Earlier this morning, we reported diluted earnings per share of $0.61 for the second quarter, an increase of 17.3% compared to $0.52 last year, which included a total of $0.06 for a net restructuring charge and a loss on a divestiture. Revenue of $1.5 billion was up 0.6% for the second quarter, but increased 2.7% excluding the divestitures of *BusinessWeek* and Vista Research.

In the current environment, regulatory and legal matters are clearly top-of-mind issues with investors, so I will start this morning by reviewing developments in these areas and their impact on Financial Services.

Financial Services

Let me say at the outset, that regarding financial reform and legal issues, we are pleased—very pleased—that this period of uncertainty is largely over. With the signing of the Dodd-Frank Act, we now have greater clarity on the new legal and regulatory landscape for credit rating agencies and that is a welcomed development. It reduces some of the uncertainty and gives us a clear picture of the way forward. From our vantage point, some things are now clear:

- First, there were no surprises in the legislation. We've been at it for some time.
- Second, we have anticipated the key provisions becoming law for some time.
- Third, the new legislation calls for greater disclosure, accountability and oversight. These are all actions that we believe will increase confidence in the markets as well as in ratings.

In this period of change, Standard Poor's has been investing in systems, processes and people to prepare us to:

- Operate effectively in the new regulated environment;
- Produce ratings that are relevant to investors, issuers and other market participants;
- Compete effectively;
- Comply with regulations in all jurisdictions; and
- Manage and mitigate risk.

The key to meeting these regulatory requirements is S&P's QCCR framework. Those initials stand for: Quality, Criteria, Compliance, and Risk.

Over the past few years, S&P has continually strengthened its QCCR framework within each of the four areas. That has meant establishing control groups independent of the ratings business and investing in staffing, training, technology and processes around the QCCR functions. Let me elaborate:

- The Quality team uses formalized review procedures to oversee the integrity, quality and transparency of S&P's ratings.
- The Criteria team oversees the development and approval of criteria for our ratings. That would include new and revised economic stress scenarios for ratings criteria to meet emerging market and regulatory expectations.
- In the Compliance organization, there are now about 50 employees helping to monitor that S&P meets regulatory requirements through regular compliance examinations. They also provide training and guidance on policies and guidelines.
- Finally, the risk control function is designed to assess various risks that could affect the integrity and quality of the ratings process. Risk control will also assess the feasibility of rating new types of securities.

More global regulation is expected, but our investment in the QCCR framework in recent years has created the foundation S&P needs to implement control and compliance functions. In short, not only is S&P well positioned now to deal with pending changes, it has a leverageable framework to deal with new regulations.

Last year, S&P spent about $63 million for QCCR-related items. In 2010, spending will increase by about $15 million, or up to about $78 million. At the beginning of the year, we said we expected a decline of about 100 basis points in the operating margin for Financial Services. Despite additional costs, the operating margin forecast has not changed. It reflects infrastructure investments and new regulatory requirements that we have anticipated. Looking ahead, there will be some pressure on operating margins as we continue to deal with all the provisions of the new U.S. legislation—new rulemaking by the SEC—and regulations recently proposed by Canada and Hong Kong.

The new Dodd-Frank Act will require more changes. Let's go through some of those changes and what they include. They include:

- The elimination of statutory references in various U.S. laws to credit ratings. We supported this action. Ratings across the globe should continue to provide investors a common and transparent language and a fundamental credit risk benchmark across sectors and geographies. Independent analytical insight and transparency are the key to our value proposition.
- Another issue, the repeal of rule 436(g): Under this rule, issuers of U.S. public offerings included the rating of a security in registration statements without triggering potential expert liability exposure for the credit rating agencies. In view of the new legal risk created by the repeal of 436(g), S&P will not consent to the inclusion of its ratings in registration statements and prospectuses. And in a new development as of yesterday, by suspending regulation AB requirements for six months—AB meaning the asset-backed area—the SEC has given the market time to study potential solutions to the problem created by the repeal of 436(g).
- But S&P will explore mechanisms outside of registration statements to allow ratings to continue to be disseminated to the debt markets. As always, S&P ratings on new issues and pre-sale reports are available to all market participants on our website. Simply log on to: `www.standardandpoors.com/newissues` and `www.standardandpoors.com/presalereports`.
- Another issue is the repeal of the exception to Regulation Fair Disclosure. Under this exception, issuers could share material non-public information with rating agencies without violating Reg FD. There are other ways to satisfy Reg FD so we can continue to receive confidential information as part of the ratings process, and we are currently evaluating those options.

The proposed change in the law that has attracted the most attention concerns new pleading standards in federal securities fraud suits brought against credit rating agencies. The legislation permits lawsuits against a credit rating agency that "knowingly or recklessly failed to conduct a reasonable investigation or obtain reasonable verification of the data it uses to determine a rating." Undoubtedly, the new pleading standard will be tested at some time in the future. More litigation would obviously be burdensome and motions to dismiss may be more difficult to achieve. But we will be ready to meet this new challenge.

Among other things, as I have already pointed out, S&P continues to make changes in its business to improve its procedures and control processes. But don't lose sight of another crucial point. It is simply this: Ultimately, the current fraud liability standard still applies. That has not changed.

And let me be clear on this point:

- The new law changes what plaintiffs are required to allege in order to survive a motion to dismiss at the pleading stage.
- The law does not change what plaintiffs must ultimately prove to a judge or jury in order for the credit rating agency to be held liable. And that is the same federal securities fraud liability standard to which all market participants are subject.

On the litigation front, the outright dismissals of current cases now stands at 13 and five cases have been withdrawn. We believe these decisions constitute meaningful precedent. Since our last update on litigation, there have been three important decisions involving S&P:

- Two involve a subprime case, and
- The third relates to S&P's index business and a grant of summary judgment that thwarts an assault on S&P's intellectual property rights.

First, the Abu Dhabi subprime case and new rulings by Judge Scheindlin. On June 15th, she emphatically denied class action certification to the plaintiffs. In denying the motion for class certification, the Judge wrote: "Defendants argue with considerable force against certifying the proposed class. As defendants point out, this action is a collection of a relatively small number of sophisticated institutional investors that acquired one of three different categories of rated notes, at different times, pursuant to different internal requirements and after conducting different due diligence inquires."

On July 20th, she allowed the plaintiffs to reinstate one of the ten original claims against both the Credit Rating Agencies and Morgan Stanley that she had previously dismissed with prejudice. In responding to the plaintiffs' motion to amend their complaint, the Judge concluded that she was mistaken in dismissing the aiding and abetting fraud claims because they are related to the allegations of fraud, the one claim that had been allowed to proceed.

There are three takeaways from this latest development:

1. The decision does not affect the dismissal of the nine claims which were not based on fraud.
2. The court has made no finding of fraud or aiding and abetting fraud. At this early stage of the case, the Court's ruling must be based on accepting the plaintiffs' assertions as true.

3. The key issue here has not changed with the restoration of the aiding and abetting claim. The plaintiffs must still prove fraud and we remain very confident that neither claim can be sustained.

The victory in the Illinois Circuit Court also was significant. Judge William Maki ruled that index providers are entitled to protection against misappropriation of their indices. The International Securities Exchange, ISE, sought to offer options based on the S&P 500 and the Dow Jones Industrial Index without obtaining a license from the owners of these indices. In his ruling, Judge Maki observed: "It bears noting that ISE unabashedly admits it attempted to create a competitive product, the ISE 250, which was an index highly correlated to the S&P 500. After spending a large sum of money developing and promoting options on the ISE 250, ISE discontinued the project which had failed to garner significant trading volume. The court fails to understand how ISE's failure somehow entitles it to profit for free from the efforts, skills and reputation of the index providers."

With that on some of the regulatory and the legal issues, I will leave that for now, and move on to the operations. Let's begin, and let's take a look at Financial Services' operating results in the second quarter and prospects for the second half of the year.

Revenue at S&P Credit Market Services was up 0.1% as a surge in syndicated leveraged bank loan rating helped offset continued softness in the structured finance market. The value of diversity was underscored by the 4.9% increase in revenue at S&P Investment Services. For the second quarter at Financial Services:

- Revenue increase of 1.6%, and
- Operating profit declined by 4.2%.

The operating margin was 38.7% compared to 41.0% last year, which reflected a pre-tax loss of $13.8 million from the divestiture of Vista Research and a pre-tax net benefit of $0.4 million from restructuring charges.

The second quarter started strongly and then softened in May and June as doubts grew about the pace of economic recovery and uncertainty developed over European sovereigns and bank debt. In this environment, credit spreads for investment- and speculative-grade bonds— and again, when we talk about credit spreads, it's the excess interest rate over Treasury bonds—began to widen after reaching two-year lows at the end of April. As this table shows, both the investment- and speculative-grade composite spreads were, on July 15, above their five-year daily moving averages. The three-month LIBOR rose to more than 0.5%, and by the way, that's the highest since the middle of 2009.

Although the volume of bank loan ratings is still at the low end of its historical average, the market picked up substantially in the first half. As this chart shows, the volume in syndicated leveraged bank loans, which are rated Triple B or lower, started climbing in the first quarter and accelerated in the second quarter of 2010. Bank loan activity was primarily amend-to-extend to push out maturities.

The investment-grade corporate market was soft in both Europe and the United States, but refinancing requirements resulted in increased high-yield debt issuance in Europe. New issuance in the high-yield market increased 15.3% globally in the second quarter with gains in European issuance more than offsetting the decline in U.S. issuance. About 73% of the total U.S. high-yield volume in the second quarter was designated for refinancing. The structured finance market declined again in the second quarter, and a key to the second half outlook is the wave of corporate debt coming due in U.S. and

European markets. As these charts show, S&P estimates that U.S. and European debt maturities by dollar amounts will grow steadily through 2014. Looking ahead, S&P expects companies to take advantage of increased investor appetite for yield to either amend credit agreements to extend maturities or refinance bank debt with longer-dated high-yield debt.

Credit spreads will be a key factor for the level of issuance in the second half. Stable or tightening spreads could spur some healthy issuance volume in the corporate sector. The outlook for public finance is mixed. Taxable bonds, including the new Build America Bonds, will probably drive growth, although S&P expects traditional tax exempt issuance to decline in the second half.

In structured finance, we may see a modest pick up in activity. There may be slow re-birth of the commercial mortgage-backed securities market in the second half. That would be welcoming. In the near-term, S&P expects to see re-REMIC activity continue in the U.S. residential mortgage-backed securities market. In the asset-backed securities market, activity could stall as various regulations are digested. The SEC's Rule 17g-5 became effective on June 2 and the FDIC Safe Harbor Rules which are expected to take effect in September.

We also continue to monitor our competitive position in the marketplace. In 2009, excluding sovereign issuance, S&P rated approximately 95% of the addressable debt issued in the U.S. As this chart shows, S&P has performed consistently in that range for the last six years. In the European market, S&P rated 89% of the addressable market last year, up from 83% in 2008. It's also worth noting that at $1.8 trillion, the rated European debt market, with fewer but larger issues, was actually bigger than the rated U.S. market, which was just over $1.5 trillion.

The market share performance underscores another important point about S&P's track record. S&P provides a range of ratings from triple A to triple C and, if the initial credit opinion meets the test of time, you will see fewer defaults at the top of the scale and higher defaults at the lower end of the scale. S&P tracks these default rates with great care and recently updated the tables on the global corporate average cumulative default rates from 1981 through 2009 and the global structured finance average cumulative default rates from 1978 through 2009. There is a lot of information on these two tables, which will appear in our new *Investor Fact Book* next month. But the key point is unmistakable. In both corporate and structured finance, over long periods of time, the higher the S&P rating the fewer defaults have been experienced. That's the way it is supposed to be if S&P is doing its job properly.

In addition to defaults S&P also looked at rating transition by conducting a comprehensive review of credit ratings—spanning the spectrum of corporate, government, and structured finance debt. The report entitled "*Default, Transition, and Recovery: A Global Cross-Asset Report Card of Ratings Performance In Times of Stress*" was published last month. This review demonstrated that ratings issued in the U.S., Europe, Japan and Australia for nearly all asset classes generally performed as expected, with the exception of ratings on U.S. residential mortgage-backed securities and on collateralized debt obligations backed by structured finance collateral. That is, rated credits withstood the recent financial crisis with results in line with expectations for the economic environment. In contrast, the performance of ratings for U.S. RMBS and CDOs issued from 2005 through 2007 had been disappointing and below our expectations.

Standard & Poor's performance review reaffirms two key attributes of ratings:

- First, even during period of economic stress, ratings have been and continue to be reasonable predictors of the relative likelihoods of default of different credits. In short, credits with higher ratings generally experience lower default rates. This trend held up across asset classes for the three stressful period studied (1991, 2001, and 2008/2009), with the exception of RMBS and CDOs during the recent crisis.
- Second, sectors other than RMBS and CDOs did not experience disproportionate downgrades relative to the degree of economic stress. Downgrades typically increase in all sectors during periods of stress, but apart from RMBS and CDOs issued between 2005 and 2007, the pace was not exceptional.

Earlier in this presentation, I mentioned the value of diversity that S&P Investment Services brings to our portfolio. Nowhere is that more evident than in S&P Indices which are providing greater access to more markets for more investors around the world. The team at S&P Indices is dedicated to finding new ways to grow the business. With the expiration of a 10-year exclusive agreement with Barclays, S&P has recently licensed Vanguard to launch exchange-traded funds based on our indices. Vanguard is introducing eight new exchange-traded funds targeting growth and value segments of the S&P 500 and growth, value and blend segments of the S&P Midcap 400 and S&P Smallcap 600.

In May, S&P licensed seven major European exchange-traded fund sponsors to create and list S&P 500 ETFs on major European exchanges for real-time trading. In the spring S&P licensed the National Stock Exchange of India to create and list Indian Rupee-denominated futures contracts based on the S&P 500. S&P will be adding new indices in commodities, fixed income, equities, strategy and customized others for its clients. The goal: an index for every type of investment.

So let's sum up for Financial Services:

- New clarity on the regulatory and legal front,
- New requirements are manageable, and
- Mid single-digit revenue growth for the segment versus our previous estimate of high single-digit growth due to some unanticipated softness in the market.

With improvement at S&P Credit Market Services and S&P Investment Services:

- Operating profit will improve, and
- Operating margin will decline approximately 100 basis points and this will reflect infrastructure investments and compliance with new regulatory requirements.

McGraw-Hill Education

Let's move on to McGraw-Hill Education.

For McGraw-Hill Education in the second quarter, a strong performance in the U.S. higher education market and increases in the state new adoption market by the School Education Group were partially offset by declines in the open territory and custom testing markets. As a result:

- McGraw-Hill School Education Group's revenue declined by 4%.
- McGraw-Hill Higher Education, Professional and International Group's revenue increased by 10.8%.

For the segment in the second quarter:

- Revenue increased by 1.8%, but the gain in U.S. higher education market had a substantial impact in the second quarter on operating profit, which grew to $51.6 million, and the operating margin, which increased to 9.1%.
- That compares to operating profit for the second quarter of 2009 of $21.0 million, which included a net pre-tax restructuring charge of $11.6 million, and an operating margin of 3.8%.

State budget pressures continue to be a factor in this year's elementary-high school market. As we had expected, only the state new adoption market will show solid growth this year, but here, too, funding concerns are driving reduced purchasing levels. As the spring adoption season progressed, it became clear that fewer California districts would be making new reading, literature, or math purchases than originally projected. South Carolina's math adoption was effectively cancelled in the second quarter when the legislature did not provide funding, and many districts in Indiana decided to postpone buying math this year. District activity has been limited in other states as well, including Georgia and Oklahoma.

In view of these conditions, we are adjusting our estimates for 2010. We now expect the state new adoption market to range from $825 million to $875 million. Our previous forecast had been $875 million to $925 million. We now look for the el-hi market to grow by 4% to 6%, down from our previous forecast of 6% to 7%. The market's growth will come from the increase of nearly 70% in state new adoption sales. We still anticipate declines in both open territory sales and residual sales.

The McGraw-Hill School Group still expects to capture about 30% of the state new adoption business this year. The biggest opportunities are in Texas, Florida, and—despite the market shrinkage there—in California as well.

- In Texas, we are forecasting a capture rate about 40% of the K–5 reading market and about 18% of 6–12 literature. Some of those orders were deferred and will be shipped in the third quarter, so we'll see that pickup there.
- In Florida, we anticipate winning 40% of the 6–8 math market and about 27% of the 9–12 market, but only 5% of the K–5 market.
- In California, strong performances by our California Treasures and Imagine It! programs should enable us to capture more than half the available dollars in the state for new K–5 reading programs.

In smaller states, the McGraw-Hill School Group expects to capture more than 40% of Mississippi's K–12 science adoption and more than 60% of West Virginia's K–12 math adoption. While math postponements have been heavy in Indiana and Oklahoma, we are winning substantial shares in those states, particularly at the 6–12 grade level.

The School Group has been strong historically in non-academic subjects and this year is no exception. We are seeing good capture rates in family and consumer sciences, technical education and business and computer education. In testing, growth in the formative market was offset by the planned phase out of statewide custom contracts in Florida and Arizona.

The increase in federal funds for education remains one of the wild cards in this market. There is no doubt that the federal government is continuing to pump significant dollars into the education market. The availability and ultimate use of these funds are developments we track very carefully, and we'll keep you informed as we go.

The massive stimulus program passed last year—the American Recovery and Reinvestment Act, or ARRA—has $11.5 billion available for distribution to the states in 2010 through Phase 2 of the State Fiscal Stabilization Fund. This fund is intended to supplement education budgets in the fiscal year that has just begun in most states. Last year most of the Phase 1 funds were used to save teaching jobs, and we believe the same will be true of the Phase 2 funds this year. But the ARRA stimulus legislation is also funding other programs that will release new dollars in 2010—Race to the Top grants at $4 billion, Common Core Assessment grants at $350 million, and Investing for Innovation grants at $650 million.

In addition, states are receiving School Improvement Grants from a $3.5 billion program funded by stimulus dollars and the U.S. Department of Education's current budget. To date, 32 states and the District of Columbia have been approved for these grants, which are earmarked for low-performing schools.

For the McGraw-Hill School Education Group, these grant programs offer potential for both assessment and instructional materials. For example, all Race to the Top proposals include formative testing, so winning states will require these products and services. Our formative products such as Acuity, Yearly ProgressPro and Writing Roadmap, and our reporting services such as the Parent Network, are naturals to meet the market's needs. At the same time, our research-based instructional and intervention products, such *Number Worlds* and *Reading Mastery*, are proven solutions for turning around low-performing schools. Timing will vary for each of these programs, but some revenue stemming from School Improvement and Investing in Innovation grants could begin to show up by at least the fourth quarter.

All this is developing as the states embrace Common Core Standards for K–12 math and for reading and language arts. To date 23 states have adopted the standards, and more are expected to follow early in August. More than 40 states are expected to sign on by the end of this year. A very important development. As a result of all this activity, we expect to see an expansion of digital delivery systems for instructional materials, professional development and classroom-level assessment. And we like these opportunities.

In higher education, the digital opportunity is big and getting bigger. Our revenue in this space is growing at a double-digit rate. The McGraw-Hill Connect family of homework management and assessment programs are currently being used by 1.8 million students and instructors. And now, by creating a partnership with Blackboard, we will dramatically increase the reach and ease of access for our suite of digital products on U.S. campuses. As the clear leader in course management, Blackboard reaches 70% to 80% of the U.S. college and university market. Students and faculty will be able to use a single Blackboard log-on to gain access to our content and tools. Scores on McGraw-Hill Connect assignments, quizzes and tests will post directly to the Blackboard grade book, eliminating the need for students and instructors to manage access and updates on two separate systems.

We are off to a solid start this year in the U.S. college and university market. And while a strong performance early in the year puts us in a good position, it is not necessarily a barometer of full-year results. Those will be determined by the heavy ordering season that we have just entered into.

We have benefited so far this year from last fall's surge in enrollments, which carried through into the spring semester. While we think fall enrollments will continue at this higher level, no further surge is projected. That is why we expect the market to grow by 5% to 7% despite the strong start to the year.

In professional markets, digital products are also producing double-digit growth. We now have 5,000 eBooks available, and their sales accelerated last April following the introduction of the Apple iPad. The eBook is on its way to becoming a staple of the Business-to-Consumer market as individuals increasingly discover the convenience of downloading content to e-reading devices.

Digital products are also growing rapidly in the Business-to-Business market. Here the content is accessed on a platform that is updated with news feeds, augmented with video, and rich with searchable information that professionals require to remain current with developments in their fields. Our growing family of Access products offers a growing array of professional resources in medicine, engineering, and business.

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

- Growth in key markets in 2010;
- 4% to 6% in the elementary-high school market;
- 5% to 7% in the U.S. college market;
- Segment revenue: Low single-digit growth, down from our previous guidance of 6% to 7% growth given a more challenging el-hi market; and
- Operating margin remains unchanged from 2009.

Information & Media

Now, let's look at the Information & Media segment:

- The growth of our global energy information business,
- An increase in television and advertising, and
- The continuing impact of the *BusinessWeek* divestiture were key to this segment's second quarter performance.

For the second quarter:

- Revenue declined by 5.1%, but excluding *BusinessWeek* grew by 7.4%;
- Operating profit increased by $33.1 million to $47.5 million, compared to $14.4 million for the same period last year which included a net pre-tax restructuring charge of $4.0 million; and
- The operating margin was 21.2% compared to 6.1% for the same period last year.

The Business-to-Business Group's revenue declined by 7.8%, but excluding *BusinessWeek* grew by 5.6%. In volatile energy markets, the demand for Platts' data and information products continues to produce solid growth in both U.S. and international markets. To keep its clients abreast of the changing marketplace, Platts is also introducing new information services. The Bakken Shale formation in the central U.S. is one of the most significant new sources of regional oil for our nation's refiners. In the second quarter Platts began publishing the world's first price assessment for crude oil produced from the Bakken Shale formation. Platts also began publishing daily price assessments for liquefied natural gas imported to Southwest Europe and to Northwest Europe, two key consumer regions.

For Broadcasting, second quarter revenue increased by 24.0% compared to the period last year. National, local and political time sales all contributed to the growth. A pick up in automotive advertising was a key factor in the improvement in local and national advertising. Political advertising benefited from the June 8th primary in California and the contest for governor in that state. In the third quarter, political advertising should again be strong. There is an August 10th primary in Colorado with spending for the Senate race and propositions expected to be key drivers.

Summing up then for Information & Media:

- 2009 sale of *BusinessWeek* is having an impact on revenue and operating margin;
- Revenue: Expect a mid single-digit decline but excluding *BusinessWeek*, revenue will increase in the mid single-digit range; and
- Operating margin: Expect to rebound into the mid-teens.

And summing up overall now for The McGraw-Hill Companies.

- Our previous earnings per diluted share guidance for 2010 was $2.55 to $2.65. Due to choppiness in some of our key markets, we now expect to finish the year at the lower end of that range.

That concludes our review of operations and various situations. Let's 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.

There should be no doubt about the strength and flexibility of The McGraw-Hill Companies' financial position as we enter the third quarter:

- Free cash flow is building;
- There is no short-term debt outstanding;
- No long-term debt comes due until 2012; and
- In the second quarter we started repurchasing shares.

We repurchased 6.5 million shares for a total cost of $186.9 million at an average price of $28.76 per share. This is the first time we have repurchased shares since the third quarter of 2008. 10.6 million shares remain in the 2007 program authorized by the Board of Directors.

Our diluted weighted average shares outstanding was 313.2 million in the second quarter, relatively flat versus prior year as 2Q share repurchases were offset by issuance related to employee plans as well as stock price appreciation. Diluted weighted average shares outstanding declined 3.1 million from the first quarter, reflecting the weighted impact of second quarter share repurchases. Fully-diluted shares at the end of the quarter were approximately 310 million.

We continue to be well capitalized; with a net debt position as of June 30th of $53 million. The shift to a net debt position from the end of the first quarter is driven primarily by funding for share repurchases. Cash and short-term investments at the end of the quarter totaled $1.145 billion, while gross debt was comprised of $1.198 billion in senior notes. Our debt is comprised entirely of long-term unsecured senior notes. No commercial paper is outstanding as I mentioned earlier.

Again, as I mentioned earlier, the outlook for free cash flow continues to improve. To calculate free cash flow, we start with after-tax cash from operations and deduct working capital, investments and dividends. What's left is free cash flow—funds we can use to repurchase stock, make acquisitions, or pay down debt. In the first half of 2010, we generated free cash flow of $98 million. That's an

improvement of $61 million from the prior year, due to improved operating results and a continuing focus on asset management.

We now expect free cash flow for the year in the range of $600 million to $650 million versus our previous guidance of $550 million to $600 million. The improvement is driven by reduced capital investment projections and more favorable working capital than previously anticipated. 2009 full-year free cash flow was $770 million. We generate the majority of our free cash flow in the second half of the year because of the seasonality of our education business. Our guidance implies second half cash flow will roughly be $500 million to $550 million, which is lower than the prior year due to increased investment and more challenging working capital comparisons during the second half.

Regarding our U.S. pension plan, we still anticipate no funding requirements in 2010. We now expect an increase in pension expense of approximately $15 million in 2010 versus our previous estimate of $20 million.

Now let's look at segment expenses, particularly in the context of the reduced revenue outlook for McGraw-Hill Education and Financial Services. As a reminder, I will speak to "adjusted" expense growth, which represents expense growth excluding 2009 restructuring charges as well as the loss on the divestiture of Vista and the gain on the divestiture of *BusinessWeek*.

Let's start with McGraw-Hill Education. Second quarter adjusted expenses declined 1.8% and first half adjusted expenses declined 2.1%. At constant currencies the first half decline is actually larger, at 3.1%. The segment benefited from savings from last year's strategy to combine our core basal publishing operations with our alternative basal and supplemental publishing operations, as well as reduced expenses due to the planned phase out of statewide custom contracts in California, Florida, and Arizona. Increases in selling and marketing costs in the second quarter for the robust state new adoption opportunities and continued digital investments partially offset these savings.

For full-year 2010, as Terry indicated, we now expect segment revenue growth in the low single-digits versus our previous guidance of a 6% to 7% increase. Despite the reduced revenue growth, we are maintaining our guidance of an unchanged adjusted operating margin as we now anticipate expenses to increase in the low single-digits compared to our previous guidance of a 6% to 7% increase. Our full-year guidance implies that second half expense will be up mid-single digits, driven by an increase in selling and marketing costs because of the state adoption calendar, as well as cycling through the phase out of the previously mentioned statewide custom contracts. Additionally, we continue to ramp up investment in both technology and personnel to support our digital initiatives, particularly at higher education and professional, in order to provide value and choices for our customers.

For Financial Services, adjusted expenses increased 9.4% in the second quarter and 10.8% at constant currencies. First half expenses increased 8.5%. Expense increase was driven by increased salaries and occupancy costs, mainly from our international hires and increased incentive compensation.

For full-year 2010, we now expect expenses to increase roughly 7% to 8%, down slightly versus our previous guidance of roughly 9% to 10% versus 2009 adjusted expense. Expense growth is largely driven by:

- Continued investment in our fast growing businesses,
- The carry over impact of 2009 hires as well as planned hires for 2010, and
- Additional investments to support our regulatory and compliance efforts.

Our expense guidance assumes approximately $15 million in additional costs related to our regulatory and compliance initiatives which will occur mostly in the second half of the year. As Terry indicated, there will be some pressure on operating margins as we continue to deal with the provisions of the new U.S. legislation, new rulemaking by the SEC, and regulations recently proposed by Canada and Hong Kong.

At Information & Media, second quarter and first half adjusted expenses declined 18.9% and 19.4%, respectively. The divestiture of *BusinessWeek* reduced second quarter revenue by $27.5 million and expenses by $38.5 million, for a positive profit impact of roughly $11 million in the quarter. For the first half, the divestiture of *BusinessWeek* reduced revenue by $55 million and expenses by $78 million, for a positive profit impact of roughly $23 million. The segment also benefited from restructuring actions taken in 2009. For the full-year, Information & Media will reflect savings from the *BusinessWeek* divestiture of $38 million. For 2010, reflecting primarily the divestiture of *BusinessWeek*, expenses are expected to decline in the low teens versus 2009 adjusted expenses.

Corporate expense in the second quarter was $37.6 million, an $8.3 million increase versus prior year. The increase was primarily driven by increased excess space, increased incentive compensation and growth in selected support functions. For the first half, corporate expense was $73.4 million, which is a $10.6 million increase. For the full year, we continue to expect corporate expense to increase $25 million to $30 million. The primary reason for the increase is driven by higher excess space in New York resulting from the *BusinessWeek* divestiture as well as excess space from restructuring actions at McGraw-Hill Education.

Let's now turn to investments, where we are expecting increases in the second half. Prepublication investments were $30 million in the second quarter, a decrease of $12 million compared to the second quarter of 2009. And in the first half we invested $60 million, which is a $25.1 million decrease. The decline is largely due to timing as we expect increased prepublication investments in the second half of the year.

For 2010, we now expect prepublication investments of approximately $195 million to $205 million, an $18 million to $28 million increase versus 2009. But, on the other hand, this investment is $30 million less than our previous estimate of $225 million to $235 million, reflecting the fact that, with changes in state adoption call schedules, investments are being delayed to better align with projected opportunities. In addition we continue to benefit from combining our core basal publishing operations with our alternative basal and supplemental publishing operations.

Purchases of property and equipment were $14.5 million in the second quarter, a $6 million increase versus the second quarter of last year. First half purchases of property and equipment were $22 million. We expect increased investment in the second half and continue to expect on a full-year basis that expenditures will be approximately $90 million to $100 million versus $68.5 million in 2009. The increase is largely driven by technology spending.

Let's now take a look at non-cash items. Amortization of prepublication costs was $69 million in the second quarter, which is a $2 million decrease versus last year. In 2010, we continue to expect $260 to $265 million, versus $270 million last year. Depreciation was $26 million in the second quarter versus $29 million in the second quarter last year. We continue to expect depreciation to be roughly $115

million versus $113 million in 2009. Amortization of intangibles was $13 million for the second quarter of 2010 and $23 million for the first half, and we expect for the full year about $40 million.

Net interest expense was approximately $21million in the second quarter, compared to $18.5 million in the same period last year and $22 million in the first quarter of 2010. We continue to expect full-year interest to be roughly comparable to 2009, which was $77 million. Regarding the Company's effective tax rate, during the second quarter and the first half 2010, it was 36.4%, which was unchanged from 2009. And that's what we expect to see for the full year.

Our unearned revenue continues to grow, ending the quarter at $1.1 billion, which is up 4.2% from the prior year. At constant foreign currency exchange rates and excluding the impact of the divestiture of *BusinessWeek*, growth was 7.0%. Unearned revenue was impacted by a deferral of revenue at McGraw-Hill Education School Education Group, where shipping will be completed in the third quarter. Excluding this impact unearned revenue would have grown at approximately 3.5%. Financial Services continues to represent 73% of the Corporation's total unearned revenue. It grew in the low single digits as strong growth in ratings-related information, S&P Indices and Capital IQ offset declines at credit ratings and equity research products. For 2010 we continue to expect mid single-digit growth in unearned revenue.

Thank you and now back to Terry.

To access the accompanying slides online, go to:
http://investor.mcgraw-hill.com/phoenix.zhtml?c=96562&p=irol-EventDetails&EventId=3208170

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