The McGraw-Hill Companies

The McGraw-Hill Companies
3rd Quarter 2010 Earnings Conference Call

Prepared Remarks
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The McGraw-Hill Companies

Thank you and good morning to our worldwide audience and thank everyone for joining us this morning at The McGraw-Hill Companies' third 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 third 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.

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

Good morning everyone and welcome to our review of third quarter earnings.

With me this morning is Bob Bahash, Executive Vice President and Chief Financial Officer.

I will start by reviewing third quarter results and our new guidance on earnings for 2010. After our presentations, we will then answer any questions you may have about The McGraw-Hill Companies and our prospects.

Earlier this morning, we reported a 15% year-over-year increase in diluted earnings per share for the third quarter. Earnings per share of $1.23 included $0.02 for the gain on some divestitures and $0.01 of dilution for the acquisition of TheMarkets.com.

Revenue grew by 5.5% in the third quarter, but increased 6.8% if you exclude the divestiture of *BusinessWeek*.

Based on that strong performance in the seasonally most important quarter of the year, we are increasing our guidance for 2010. We now anticipate earnings per share this year in the $2.60 to $2.65 range and expect to achieve the high end of that range. The new guidance excludes the one-time gain of $0.02 from divestitures, but includes dilution of $0.02 from acquisitions.

There were many contributors to our strong third quarter. We are very pleased to be firing on so many cylinders. This morning we will provide the details on how those results were achieved.

Financial Services

Let's start the review with Financial Services segment.

The third quarter is normally the slowest each year in the ratings business, but not in 2010 when S&P Credit Market Services produced the most revenue in any quarter so far this year. It is also noteworthy that the growth is coming without the benefit of a recovery in the structured finance market and despite a decline in European issuance.

- Revenue for S&P Credit Market Services in the third quarter increased by 11.1% based on a strong performance in domestic markets.
  - Domestic revenue grew by 20.9%.
  - International revenue was up 0.9%.
- Revenue for S&P Investment Services grew by 6.3%.

For Financial Services in the third quarter:

- Revenue grew by 9.5%.
- Including a $7.3 million pre-tax gain on divestitures, operating profit increased by 6.6%.
- The operating margin was 39.2%. It reflects the pre-tax gain on the divestitures and increases in incentive compensation; incremental costs for compliance and substantial staff increases overseas, mainly in India; and the acquisition of TheMarkets.com.

Our revenue growth was driven by:

- Increased refinancing activity,
- The investors' search for yield,
- A robust bank loan market, and
- Recovery in the equity market, which benefited S&P Indices.

Spreads—the excess interest rate over Treasury bonds—is a key factor in the level of issuance volume. The composite spread on speculative-grade bonds hit a two-year low at the end of April at 553 basis points and then began widening. But spreads began tightening in September and, as our table shows, that trend has continued into October.

At S&P Credit Market Services, the global high-yield new issue market took off in the third quarter. After a slight decline in new issuance in July, compared to the same period last year, the global high-yield market started climbing in August and kept on climbing in September. The global high-yield market has already produced more new issue dollar volume in nine months this year than it has in any previous single year.

Companies are taking advantage of falling yields to refinance debt and repair their balance sheets. As this S&P report shows, more than two-thirds of the high-yield volume in the United States went for refinancing in the third quarter and for the year-to-date. High-yield issuers are finding a receptive market as investors search for yield at a time when cash is producing anemic returns.

And, as banks continue to deleverage, investment-grade issuers are also stepping up their activity in the bond market to lock in low yields. The composite spread for investment-grade bonds widened over the past month when it was 200 basis points. The spread in mid-October of 203 basis points is still slightly above the five-year daily moving average of 198 basis points.

Global bank loan ratings also soared in the third quarter, although the absolute volume is still on the low end of the historical averages. Fundamentals remain strong. Liquidity is good in the United States and only slightly less so in Europe.

There is usually a seasonal slow down in the summer months in the muni-market. But while the dollar volume of public finance issuance declined in the third quarter, deal volume actually increased. It was fueled by refundings, which were up 11%, and the taxable Build America Bond Program. The taxable bond program, which was launched last April, has been a boon to municipalities. Taxable bond debt year-to-date accounts for 32% of the muni market.

The structured finance market is still struggling to recover.

The current residential mortgage-backed securities market cannot compete with the spreads on structured vehicles that benefit from explicit or implicit government support provided to Fannie Mae, Freddie Mac, and Ginnie Mae.

Refinancing needs have been the source of securitizations for residential mortgage-backed and commercial mortgage-backed securities this year. But re-REMIC activity declined in the third quarter and the residential mortgage-backed market remains under pressure in the face of continued uncertainty over home prices and a sluggish economic recovery.

We are seeing AAA-rated, three-year spreads across major ABS asset classes—auto, credit cards and student loans—continue to tighten. The asset-backed securities market has benefited all year from strong auto and student loan issuance, which helped offset a general slow down in credit card issuance. New regulatory requirements and higher capital costs of bank securitizations have tempered credit card issuance this year.

New issuance in the fourth quarter is off to a solid start for corporates. It appears that high-yield issuers are continuing to find a receptive market and investment-grade issuers are still taking advantage of attractive funding rates. We also expect cash to continue to pour into the leveraged loan market, filling the institutional pipeline. Favorable rates and heavy demand should continue to fuel this market.

The structured finance market will also have to adjust to a number of new measures resulting from the Dodd-Frank legislation, new FDIC Safe Harbor rules, and new SEC regulations that impose restrictions on sponsors of securitization and greater regulatory oversight on transactions. Greater disclosure and transparency will benefit investors and, after a period of adjustment, S&P expects the use of securitization to be a significant funding tool for many issuers in the years ahead.

In S&P Investment Services, growth at S&P Indices and expansion by Capital IQ were clearly third-quarter highlights.

Assets under management based on S&P Indices in exchange-traded funds set a new record at the end of September—$260.4 billion. That's a 17.9% year-over-year increase and a 12.9% sequential increase over the second quarter of 2010. Growth in SPDR and iShares in exchange-traded funds were major contributors to the growth.

19 new exchange-traded funds linked to S&P indices were launched in the third quarter. That includes nine new Vanguard exchange-traded funds based on our core U.S. indices, including the S&P 500. In the aggregate, there are now 278 exchange-traded funds based on S&P Indices.

There also was 7.3% growth in the average daily volume for major exchange-traded derivatives based on S&P Indices. The daily average in the third quarter was 3,069,000.

At the end of each quarterly report, we say to expect more new indices from us. This quarter is no exception. You can expect them in various asset classes, including commodities, fixed income, and equities.

There also was an historic first for S&P Indices in the third quarter. They licensed the Options Clearing Corporation to handle trades of over-the-counter S&P index-based option contracts and to receive royalties. This is the first time S&P has licensed its indexes to a clearing house for central counterparty clearing.

Capital IQ continued its expansion in global markets with the acquisition in September of TheMarkets.com. The acquisition positions Capital IQ for significant growth on the buy-side. There is only modest overlap between TheMarkets.com's more than 2,000 clients and Capital IQ's 3,300 clients. We expect to:

- Add clients
- Add revenue
- Create cost synergies
- Grow in both domestic and international markets

With this acquisition, Capital IQ now has earnings models, estimates, and fixed income research that are all a key part of the buy-side's workflow.

This diagram illustrates how the acquisition improves Capital IQ's competitive offering to the buy-side, private equity and venture capital, and investor relations and business development departments at corporations. Those open circles indicate little or no availability. This acquisition fills in these circles with a complete investment research and analysis platform for asset managers worldwide based on contributions from more than 1,000 research and estimate contributors.

On the regulatory front, a lot of the uncertainty is now behind us.

- S&P has filed its application as called for by European regulations, which took effect on September 7. S&P expects to be registered later this year.
- S&P received its license in Japan as an approved agency before the October deadline.
- We are also discussing new regulatory proposals with Hong Kong, Canada, and Taiwan.
- In the United States, SEC rule-making will be required to implement many of the provisions of the new Dodd-Frank Act. We continue to engage with the SEC and market participants as part of the rule-making process.

In anticipation of new regulations, S&P has made significant investments in technology platforms and staffing for quality, criteria, compliance, and risk management. We call this our QCCR framework. These are four individual groups within S&P that perform these various functions.

In 2009, S&P spent about $63 million for QCCR-related items. This year, spending will increase by about $15 million, mostly in the second half of this year. On a preliminary basis, incremental costs next year could be somewhere in the $12 million to $15 million range—we're still trying to narrow in on that. Price increases have helped us mitigate some costs, including the incremental expenses for QCCR-related items. We expect that price increases will help us again next year.

We also continue to monitor the impact of new regulations on bank lending. Regulators are forcing banks to shrink their balance sheets. It is already apparent that banks are retrenching and sitting out one of the busiest periods in the corporate bond market. With banks expected to keep more capital, it is inevitable that they will support less debt. And reduced bank lending is a plus for public debt markets.

Our assessment of legal risk facing the corporation is low and that remains unchanged. Fifteen of our motions to dismiss complaints have now been granted and five more cases have been withdrawn—that's 20.

Last Friday, there was another favorable ruling. In the case of Rice versus S&P and Moody's, a federal district court in California dismissed with prejudice a complaint concerning plaintiffs' investments in Fannie Mae securities. Some key points in this decision are worth studying.

In dismissing the intentional misrepresentation claim, Judge Cormac J. Carney wrote (quote) *"Defendants' credit ratings are opinions of the future creditworthiness or value of companies…and therefore are not actionable unless Plaintiffs can demonstrate the Defendants' representatives who published credit ratings actually knew the credit ratings were false or did not believe that the credit ratings were true at the time that each credit rating was issued."* (close quote)

The Judge also recognized that a negligent misrepresentation claim concerning a professional opinion can only be stated by (quote): *"a narrow and circumscribed group of persons to whom or for whom the misrepresentations were made…The rationale for limiting liability to a specific group of persons is to protect professionals who provide information from unlimited and uncertain liability."* (close quote)

In these important ways, this ruling recognizes limitations facing plaintiffs who seek to assert legal claims concerning S&P's ratings.

In Italy, there was a development earlier this month in the Parmalat litigation, which got started in the fall of 2005. On October 1, two court-appointed experts—both accountants—filed a report that was critical of the ratings assigned to Parmalat by S&P during the timeframe of 2000 to 2003.

The S&P expert disputed the methodology, findings, and conclusions of the accountants' report, which as a matter of law, is not binding in court. The judge, who appointed the two accountants to assist in her determination, has scheduled a hearing in early January. We continue to believe that the outcome of this litigation against two subsidiaries of The McGraw-Hill Companies should not have a material adverse effect on our condition.

Let's sum up for Financial Services:

- We expect revenue growth in the mid single digits,
- We had expected a 100 basis-point decline in the operating margin. We now expect a 150 basis-point decline in the operating margin, primarily due to the acquisition of TheMarkets.com.

McGraw-Hill Education

Now, let's move over to the McGraw-Hill Education operations.

In the seasonally most important quarter of the year for education, we grew in both the elementary-high school market and the U.S. higher education market. And we did so with an operating margin of 33.9% for the segment, which includes 40 basis points from the gain on a divestiture. That still makes this year's third-quarter performance by McGraw-Hill Education the best since 2007 when an operating margin of 35.0% was reported.

For McGraw-Hill Education in the third quarter:

- Revenue increased by 5.5%.
- Operating profit, including a $3.8 million pre-tax gain on a divestiture, grew by 19.9%.
- The operating margin of 33.9% compares to 29.8% for the same period last year.
- Control of costs and expenses and improved results in the elementary-high school market and U.S. higher education market contributed to this performance.
- Revenue for the McGraw-Hill School Education Group increased by 6.7%.
- Revenue for the McGraw-Hill Higher Education, Professional and International Group grew by 4.3%.

As we had expected, state new adoptions were key to our performance in this year's el-hi market. We are on track to capture about 30% of this year's state new adoption market. At $825 million to $875 million this year, the state new adoption market will grow by 65% to 75% over last year. This increased spending is the prime reason why we expect the el-hi market to grow 4% to 6% this year.

According to the most recent Association of American Publishers' report, sales in the el-hi market were up 8.0% through August because of a 24.7% increase in state adoption sales. Open territory sales after eight months were down 7.3%. These non-adoption states represented 44.8% of this year's revenue.

Based on the August results, the el-hi market could hit the high end of our 4 to 6% growth forecast if industry sales remain flat in the last four months of 2010. As this bar chart shows, industry sales grew in each of the last four months of 2009, so achieving that level of growth will be challenging. September results for the industry are not yet available, but indications are that overall sales slowed during the month, adding to the challenge.

For McGraw-Hill, however, September was another strong month, especially in the adoption states.

Reading, literature, and math represented the biggest revenue opportunities in this year's state new adoption market. The McGraw-Hill School Education Group did particularly well in the very large K–5 reading market. With strong performances in Texas and California, the School Group expects to capture about 45% of the K–5 reading market and approximately 32% of the K–12 reading and literature opportunity. The School Group's K–5 *Treasures* program is the key to its success in reading.

In math, the School Group expects to win more than 40% of the secondary school market with programs in Florida, California, Indiana, West Virginia, and Oklahoma. But underperformance in Florida's K–5 math adoption will probably hold our overall capture rate in K–12 math to about 28%.

Open territory sales were down in the third quarter for us as well as for the industry, a reflection of budget pressures in such states as New Jersey, Michigan, Illinois, and Missouri.

In testing, the third quarter is normally slow and this year we had the additional impact of the planned phase out of custom contracts in Florida, California, and Arizona. Procedural delays in signing some important contracts were also a factor, but those issues will be settled in the fourth quarter, a seasonally important period in the testing market.

A really fine year is taking shape in the U.S. higher education market. For the second year in a row, the U.S. higher education market is benefiting from increased enrollments. An important driver is the federal government's huge step up in student aid. Under the new administration, spending on student aid has increased by nearly 50% to $145 billion.

We think increased aid is reflected in the growing higher education enrollments that we are seeing at the start of the new school year. Preliminary information indicates that fall enrollments at colleges and universities grew by 4% to 5% this year—an increase we had not anticipated at the beginning of 2010. Enrollments in the fall of 2009 grew by 7% to 8%.

All of our major product lines produced year-over-year growth in the higher education market in the critical third quarter. And there is added impetus from the double-digit growth of digital products and services.

Our lineup of homework management, assessment, and tutoring products for college and university students is gaining traction and expanding the addressable market. Through September, registrations for these products have grown to 1.9 million, a 26% year-over-year increase. McGraw-Hill Connect, our all-digital teaching and learning platform, is our leader in this rapidly growing market and we continue

to strengthen it. That's why we recently acquired Tegrity, whose scalable, automated lecture capture service has become a core feature of McGraw-Hill Connect since it was introduced last fall. Lecture capture gives students the ability to review material presented in the classroom anytime, anywhere for replay online or on any mobile device. That is a powerful tool for studying and learning. More than 200 educational institutions already use the Tegrity cloud-based service.

We have also launched McGraw-Hill Create, a Google-like search engine that enables instructors to customize quality content for their courses. They can draw on:

- 4,000 McGraw-Hill textbooks,
- 5,500 articles,
- 11,000 literature, philosophy, and humanities readings, and
- 25,000 business case studies from such providers as the Harvard Business School.

Once a customized text has been developed on Create, the instructor can get a digital review copy in less than an hour. Printed review copies will be delivered in only three to five days. Students can purchase McGraw-Hill Create e-books through the McGraw-Hill e-bookstore or buy printed copies at the campus bookstore. And through the recently announced partnership with Blackboard, instructors will have access to the full suite of McGraw-Hill Create content through their Blackboard accounts.

If you are looking for a window into our future in digital and international markets, take a look at this next slide. It is a custom site for the Arab Academy for Science, Technology and Maritime Transport in Egypt. It is hosted on McGraw-Hill Education's international Create e-bookstore, which is now live around the world. The McGraw-Hill Create e-bookstore made it possible to deliver 36 titles to this Egyptian institution for students to use in their new semester.

The customer selection of 36 titles underscores the scope of McGraw-Hill's global content creation. The list includes titles drawn from U.S. McGraw-Hill higher education, our U.S. professional catalog, as well as original titles published by our subsidiaries in India and Europe. Because of the capabilities of McGraw-Hill Create, 30 of the titles will be delivered directly to students using institutionally purchased access codes. At the school's request, six titles will be delivered as e-books for testing the student experience with the enTourage eDGe™, a new e-reader.

Another site has been established at the Rotterdam School of Business in The Netherlands. Using McGraw-Hill Create, that micro-site will host 29 custom e-books from our catalog for student purchases.

One more observation about using McGraw-Hill Create to deliver e-content: In this world, we are not supplying physical products. That means:

- No printing and binding costs,
- No inventory or warehousing costs,
- No shipping charges,
- No returns,
- No used books.

Clearly, connecting content and managing digital assets globally is a powerful combination that is creating new opportunities as we shift away from our legacy model to an interactive and digital model.

The same transition is taking place in professional markets. Here we are seeing an acceleration in the online ordering of hard copies and a huge increase in the sale of e-books. Since the beginning of the year, our e-book sales through the major e-book retailers to consumers have nearly tripled. Our best-selling e-books in the third quarter range from the *Presentation Secrets of Steve Jobs* to the famous Graham and Dodd work, *Security Analysis*.

We have more than 5,000 professional titles available as e-books.

Even with the continued rapid growth of digital products and services, the fourth quarter this year will be challenging. Last year, we had a significant upswing in operating profits based on a surge in second semester orders in the U.S. higher education market and improved results in professional and international markets. The bulk of second semester ordering in higher education sometimes occurs in December but in other years it comes in January, complicating fourth quarter forecasting in this market. The U.S. higher education market is forecasted to grow 8% to 10% this year.

There is pent up demand in the el-hi market, but budget pressures are continuing to constrain school district spending in many regions. The arrival of new federal funds could be a positive factor, however. The McGraw-Hill School Education Group's sales teams are still working on a number of large basal adoptions in the open territory as well as some excellent fourth-quarter opportunities for intervention products across the country. Federal funding will clearly play a part in some of these purchases, but in other cases it will be harder to identify because large district orders tend to be paid for through a blend of funding sources, so it is difficult to predict what will materialize.

Let's sum up for McGraw-Hill Education:

- Revenue: We still expect a low single-digit increase.
- Operating margin: We had been forecasting flat margins. We now expect an improvement of 200 basis points to 14% for 2010.

Information & Media

Now, let's review our third segment, Information & Media.

Key contributors to this segment's third quarter performance were the continued solid growth of our global energy information business, an increase in television advertising, and the effect of the *BusinessWeek* divestiture.

In the third quarter:

- Revenue declined by 4.7%, but excluding *BusinessWeek*, grew by 5.1%.
- Operating profit increased by 55.1% or $16.3 million.
- The operating margin was 20.1%, up from 12.4% for the same period last year.

The Business-to-Business Group's revenue declined by 7.1%, but excluding *BusinessWeek*, increased by 3.3%.

In volatile energy markets, the demand for Platts' data and information products continues to drive strong growth in both U.S. and international markets. Incidentally, more than 60% of Platts' revenue comes from outside the United States.

Platts is growing rapidly across a number of commodities. It is continuing to expand its coverage of the refined petroleum markets in the United States, Europe and Asia, with new price assessments in gasoline, fuel oil, and naphtha—a raw material for gasoline.

Platts expanded its suite of daily spot price assessments to include alumina, a mineral produced from bauxite ore and used to make aluminum. The new price assessments, the world's first daily price references for alumina, address the needs of miners, smelters, refiners, and traders for an independent source of open-market spot prices to better determine valuations for short- and long-term contracts.

Platts also began producing new price assessments in the India coal market. India's thermal coal imports are changing trade flows radically and increasing the need for expanded, more frequent, and transparent price information. These new assessments address the needs of power producers, coal traders, and ship brokers for an independent source of India-related open-market spot prices making Platts even more relevant in this growing market.

There was some softness in construction, particularly among smaller regional contractors who have been hardest hit by declining activity in this market.

Weakness in the global automotive business offset improvement in the non-auto market at J.D. Power and Associates.

Revenue for the Broadcasting Group increased by 23.5% to $23.6 million. A combination of political advertising and improved local and national time sales accounted for the increase. In this political season, the contest for governor, a heated race for a Senate seat, and issue-related advertising in Colorado are attracting significant ad dollars.

Summing up for Information & Media:

- There is no change in our revenue guidance. We still expect a revenue decline in the mid single-digits, but mid single-digit growth excluding *BusinessWeek*.
- We now expect the operating margin in the mid- to high-teens. We had anticipated an operating margin in the mid-teens.

That concludes our review of operations.

Summing up for The McGraw-Hill Companies:

- We anticipate earnings per share in the $2.60 to $2.65 range and expect to achieve the high end of that range. The new guidance excludes $0.02 of one-time gains from divestitures, but includes dilution of $0.02 from acquisitions.

Now, let's hear from Bob Bahash, our chief financial officer.

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

Thank you Terry.

It has been an active and productive third quarter, so this morning I am going to focus on:

- Strategic acquisitions
- Divestitures
- Share buy backs
- Improved outlook for cash flow
- Expenses

We recently announced three acquisitions:

- The research and estimates business of TheMarkets.com for Capital lQ,
- Tegrity, which becomes part of the McGraw-Hill Education Higher Education, Professional and International Group, and
- Pipal Research by CRISIL.

The acquisition of Tegrity closed in October and Pipal Research is expected to close in the fourth quarter.

We expect to spend approximately $360 million on these acquisitions and a recent equity investment in Ambow Education, a leading provider of educational and career enhancement services in China.

The most significant of the acquisitions, of course, is TheMarkets.com. It diluted earnings per share by $0.01 in the third quarter and will do so again in the fourth quarter. In 2011, TheMarkets.com acquisition is expected to generate approximately $60 million in revenue and, despite an anticipated $15 million in intangible amortization, the acquisition will be both accounting and cash flow accretive in 2011.

We also had three divestitures in the third quarter:

- A small secondary school business in Australia, which generated a $3.8 million pre-tax gain,
- And two by CRISIL. They are:
  - A 7% equity interest in the National Commodity and Derivatives Exchange of India. We continue to maintain a 5% ownership. The divestiture was required to comply with local regulations regarding foreign ownership rules.
  - And, CRISIL's remaining 10% interest in Gas Strategies Group. 90% interest was sold in December 2008.

The two CRISIL divestitures this year generated $7.3 million in pre-tax gains. Because CRISIL is a non-wholly owned subsidiary, part of the gain is deducted for purposes of calculating EPS and is shown as a component of "net income attributable to noncontrolling interests." This was $2.3 million, which represents the post-tax portion of the gain attributable to the minority owners of CRISIL.

In addition to the acquisitions, we continued to actively repurchase shares. In the third quarter, we repurchased 2.2 million shares for a total cost of $69 million at an average price of $31.14 per share.

Year-to-date we have repurchased 8.7 million shares for $255.8 million, averaging $29.37 per share. 8.4 million shares remain in the 2007 program authorized by the Board of Directors.

Our diluted weighted average shares outstanding was 309.3 million in the third quarter, a 4.4 million decrease versus the previous year due primarily to the full impact of second quarter share repurchases. Diluted weighted average shares outstanding declined 3.9 million from the second quarter, reflecting the full impact of second quarter share repurchases as well as the weighted impact of third quarter share repurchases.

Fully-diluted shares at the end of the quarter were approximately 308 million.

We continue to be well capitalized; with net cash and short-term investments as of September 30th of $157.7 million. The shift to a net cash position from a net debt position of $53 million at the end of the second quarter is driven primarily by strong free cash flow, partially offset by funding for acquisitions and share repurchases.

Cash and short-term investments at the end of the quarter totaled $1.356 billion, while gross debt was comprised of approximately $1.2 billion in senior notes. Our debt is entirely in long-term unsecured senior notes. No commercial paper is outstanding.

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.

During the third quarter, our seasonally strongest quarter, we generated free cash flow of $552 million. Year-to-date in 2010, we generated free cash flow of $651 million versus $507 million in the same period last year, for an increase of $144 million. The improvement is due primarily to stronger operating results, and a continuing focus on asset management.

We now expect free cash flow this year to be clearly in excess of $700 million versus our previous guidance of $600 million to $650 million. The improvement is driven by stronger operating results, reduced capital investment projections, and more favorable working capital than previously anticipated. Just as a reminder, free cash flow last year was $770 million.

Regarding our U.S. pension plan, we made a $14 million discretionary contribution in the third quarter. We anticipate making an additional discretionary payment in the fourth quarter, potentially in the range of $50 million. That is factored into the free cash flow projections.

Now let's look at expenses. As a reminder, I will speak to "adjusted" expense growth, which represents expense growth excluding 2009 restructuring charges as well as 2009 and 2010 gains and losses on divestitures.

Let's start with McGraw-Hill Education. Third quarter adjusted expenses were roughly flat, declining 0.1%. Year-to-date adjusted expenses declined 1.3%.

Contributing to the lower expense levels were two key decisions last year. The first was to combine the core basal publishing operations with our alternative basal and supplemental publishing operations. The second was the planned phase out of statewide, low-margin custom testing contracts in California,

Florida, and Arizona. A $15 million decline in amortization of prepublication costs also benefitted third quarter results. Increases in selling and marketing costs for the robust state new adoption opportunities and continued digital investments partially offset these savings. As Terry has indicated, we now expect margin improvement—approximately 200 basis points versus our previous guidance of flat margins.

For Financial Services, adjusted expenses increased 13.3% in the third quarter and 12.8% at constant currencies. Year-to-date, adjusted expenses increased 10.1% and 9.3% at constant currencies. The growth in expenses in the third quarter and year-to-date was driven by increased salaries and occupancy costs, primarily for international hires, and higher incentive compensation.

Third quarter expenses were also impacted by TheMarkets.com acquisition. That resulted in an incremental $5 million in expense. There also was $5.4 million in additional costs related to our regulatory and compliance initiatives. Taken together, these increased total Financial Services' expense by 2.7%. The fourth quarter is expected to show a comparable increase in costs related to our regulatory and compliance efforts. We are still projecting additional full year costs of approximately $15 million, as Terry stated.

One last comment on Financial Services' third quarter expense growth. In the beginning of the year, I indicated that total stock-based compensation for McGraw-Hill was expected to increase roughly $30 million versus 2009, due to the three-year earning and vesting period, which is off a depressed base. Due to stronger operating results, we now expect an increase of roughly $40 million. The majority of this increase, as anticipated, was realized in the third quarter due to particularly depressed levels in the third quarter 2009. As a result, Financial Services had a $10.6 million increase in stock-based compensation for the quarter.

As Terry indicated, we now expect Financial Services' margins to decline by approximately 150 basis points, which implies expenses will increase roughly 9% to 10% versus our previous guidance of 7% to 8%. That increase is largely driven by TheMarkets.com acquisition.

At Information & Media, third quarter and year-to-date adjusted expenses declined 13.1% and 17.4%, respectively.

The divestiture of *BusinessWeek* reduced third quarter revenue by $22 million and expenses by $32 million, for a positive profit impact of roughly $10 million in the quarter. Year-to-date, the divestiture of *BusinessWeek* reduced revenue by $78 million and expenses by $111 million, for a positive profit impact of $33 million. For the fourth quarter, divestiture of *BusinessWeek* is expected to reduce revenue by $22 million and expense by $27 million, for a positive profit impact of $5 million. That will result in full-year savings of $38 million.

For 2010, we expect adjusted expenses to decline in the mid teens versus our previous guidance of a decline in the low teens.

Corporate expense in the third quarter was $44.4 million, a $16.5 million increase versus the prior year. The increase was primarily driven by increased incentive compensation compared to lower levels in 2009, as well as normal increases due to the stronger operating results. Increased excess vacant space was also a contributor to increased corporate costs.

We are making progress in reducing excess space. We finalized one agreement to sub-lease some excess space in New York this month and have received several promising inquiries regarding additional space. Because we are subleasing the space at lower rates than what we are currently paying, accounting rules require us to take a one-time charge for the difference between the present value of the payments we will receive versus the payments we have to make over the term of the lease. Our new earnings per share guidance excludes this one-time charge since we are still finalizing the accounting for this charge.

Excluding this charge, we now expect full year 2010 corporate expense to increase $30 million to $35 million versus our previous guidance of an increase of $25 million to $30 million due to additional incentive compensation accruals.

Net interest expense was $19.3 million in the third quarter, compared to $17.8 million in the same period last year and $20.8 million in 2Q 2010. We continue to expect full-year interest to be roughly comparable to 2009, which was $76.9 million.

The company's effective tax rate in the third quarter and year-to-date was 36.4%, unchanged from 2009. We expect a comparable rate for the full year.

Let's now turn to investments.

Prepublication investments were $39.3 million in the third quarter; $5.4 million lower than last year. Year-to-date, prepublication investments were $99.3 million, a $30.4 million decrease versus the prior year. For the year, we now expect prepublication investments of approximately $160 million versus our previous estimate of $195 million to $205 million.

The reduction in our prepublication investment estimate is due to several factors:

- First, the timing of the adoption of Common Core Standards by various states. To date, 36 states and the District of Columbia have adopted the standards for K–12 math, reading and language arts.
- Also, we continue to re-evaluate several programs to enhance our digital offerings. These actions have caused timing delays for a number of our prepublication investments.
- In addition, we continue to realize savings from combining our core basal publishing operations with our alternative basal and supplemental publishing operations.

Purchases of property and equipment were $16.6 million in the third quarter, about $1 million higher than last year. Year to date purchases of property and equipment were $38.6 million. We now expect full-year expenditures to be in the $70 million to $80 million range, versus the previous estimate of $90 million to $100 million. This compares to $68.5 million in 2009.

Let's now take a look at some of the non-cash items.

Amortization of prepublication costs was $112.0 million in the third quarter 2010, a $15.2 million decrease versus the third quarter 2009. For the full year, we now expect $245 million to $250 million versus our previous estimate of $260 million to $265 million. This compares to $270 million in 2009. The decrease reflects the recent lower level of investments.

Depreciation was $24.8 million in the third quarter compared to $26.0 million in the third quarter 2009. We now expect full-year depreciation to be slightly below last year, which was $113 million.

Amortization of intangibles was $9 million for the third quarter of 2010 and $32 million for the first nine months. Reflecting the impact of our recent acquisitions, we now expect it to be closer to $50 million for the full year versus our previous estimate of $40 million.

Our unearned revenue continues to grow. We ended the quarter at $1.1 billion, up 4.2% from the prior year. At constant foreign currency exchange rates and excluding the impact of the acquisitions and divestitures, growth was approximately 5%. Financial Services represented 74% of the Corporation's total unearned revenue. It grew in the low single digits driven by strong growth in ratings-related information products, S&P Indices, and Capital IQ. While still small, unearned revenue at McGraw-Hill Education is showing strong growth due to sales of digital 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://phx.corporate-ir.net/phoenix.zhtml?c=96562&p=irol-EventDetails&EventId=3431186

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This presentation includes certain forward-looking statements about our businesses and our prospects, new products, sales, expenses, tax rates, cash flows, prepublication investments and operating and capital requirements. Such forward-looking statements include, but are not limited to: the strength and sustainability of the U.S. and global economy; the duration and depth of the current recession; Educational Publishing's level of success in 2010 adoptions and in open territories and enrollment and demographic trends; the level of educational funding; the strength of School Education including the testing market, Higher Education, Professional and International publishing markets and the impact of technology on them; the level of interest rates and the strength of the economy, profit levels and the capital markets in the U.S. and abroad; the level of success of new product development and global expansion and strength of domestic and international markets; the demand and market for debt ratings, including corporate issuance, CDO's, residential and commercial mortgage and asset-backed securities and related asset classes; the continued difficulties in the credit markets and their impact on Standard & Poor's and the economy in general; the regulatory environment affecting Standard & Poor's; the level of merger and acquisition activity in the U.S. and abroad; the strength of the domestic and international advertising markets; the strength and the performance of the domestic and international automotive markets; the volatility of the energy marketplace; the contract value of public works, manufacturing and single-family unit construction; the level of political advertising; and the level of future cash flow, debt levels, manufacturing expenses, distribution expenses, prepublication, amortization and depreciation expense, income tax rates, capital, technology, restructuring charges and other expenditures and prepublication cost investment.

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