McGraw Hill Financial
1st Quarter 2013 Earnings Conference Call
Prepared Remarks
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Good morning. Thank you for joining us this morning for The McGraw-Hill Companies' first quarter 2013 earnings call. I am told that that will get you through. Presenting on this morning's call are Harold McGraw III, chairman, president and CEO, and Jack Callahan, chief financial officer. Also joining us is Ken Vittor, our General Counsel.

This morning we issued a news release with our results. I trust you have all had a chance to review the release. If you need a copy of the release and financial schedules, they can be downloaded at www.mcgraw-hill.com.

In today's earnings release and during the conference call we're providing adjusted financial information. This information is provided to enable investors to make meaningful comparisons of the Corporation's operating performance between periods and to view the Corporation's business from the same perspective as management's. The earnings release contains exhibits that reconcile the difference between the non-GAAP measures and the comparable financial measures, calculated in accordance with U.S. GAAP. The results also reflect the classification of McGraw-Hill Education as a discontinued operation.

Before we begin, I need to provide certain cautionary remarks about forward-looking statements. Except for historical information, the matters discussed in the teleconference may contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, including projections, estimates, and descriptions of future events. Any such statements are based on current expectations and current economic conditions and are subject to risks and uncertainties that may cause actual results to differ materially from results anticipated in these forward-looking statements. In this regard, we direct listeners to the cautionary statements contained in our 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 intended for investors and we would ask that questions from the media be directed to Jason Feuchtwanger in our New York office at (212) 512-3151 subsequent to this call.

Now, I would like to turn the call over to Harold McGraw III. Terry.

Harold McGraw III
Chairman, President and CEO
McGraw Hill Financial

Thank you, Chip. Good morning everyone. Thanks for being with us and welcome to today's conference call.

Today we report the first quarter earnings of our first year as a new company—McGraw Hill Financial. By the way, approval of our new name is anticipated at the annual meeting of shareholders tomorrow. The new name characterizes our unique set of businesses. McGraw Hill Financial is a company that, since its founding in 1888, has continuously responded with innovative new products to satisfy the evolving needs of the marketplace.

Along with our new name we will be introducing a new ticker symbol on May 14th—and that is MHFI. Our stock will continue to trade on the New York Stock Exchange. To celebrate this symbolic change, we will be ringing the closing bell at the NYSE on the 14th.

McGraw Hill Financial is a company that provides essential intelligence to the markets it serves. Our vision is to be the foremost provider of ratings, benchmarks, and analytics in the global capital and commodity markets. We will promote sustainable growth by bringing transparency and independent insights to the global capital and commodity markets.

We are fortunate to have assembled, through our own innovation as well as through various acquisitions, a unique set of businesses. We have iconic brands and leading market positions in growing markets around the world. We are experts in creating and monetizing benchmarks such as:

- the S&P 500,
- the dated Brent oil price,
- the J.D. Power customer satisfaction award,
- and, of course, an S&P credit rating.

Our benchmarks are integral to our customers' commerce and, unlike many other businesses, have remarkable perpetuity. These businesses require minimal capital investment while generating substantial cash flow. And we, as stewards for the shareholders, have demonstrated our commitment to maximizing shareholder value through thoughtful deployment of that cash toward targeted acquisitions, dividends, share repurchases, and so forth.

We are excited about our new Company and are eager to launch it to the financial world. To that end, we will be launching a new branding campaign in the fall to inform the markets about McGraw Hill Financial. This slide depicts one of the posters that will be prominently displayed as part of the campaign.

Let me now turn to the financial performance during the first quarter. Our full-year 2013 guidance called for high single-digit revenue growth and approximately 15% diluted adjusted EPS growth. However, during the first quarter, we delivered 14% revenue growth and 29% diluted adjusted EPS growth—up to $.80 per share. While we are clearly off to a solid start, keep in mind that comparisons will become more difficult because in each quarter of 2012 we delivered sequential increases in revenue and diluted adjusted earnings per share. But we're very pleased with the start to this year.

On this slide, these two pie charts should help put into perspective the revenue and operating contribution of each of our business segments. Not surprisingly, Standard & Poor's Ratings Services is our largest segment with each of the remaining three contributing a comparable level of operating profit.

Standard & Poor's Ratings Services

After a strong performance in 2012, Standard & Poor's Ratings Services is off to a great start in 2013.

Revenue for the segment grew 20%, setting a new record for a first quarter. Segment operating profit increased 39% and the corresponding operating margin increased more than 600 basis points to 46%. With inherent uncertainty regarding continued favorable issuance volume and mix, as well as additional compliance spending necessary to comply with final CRA3 regulations, the 46% margin will likely moderate in the upcoming quarters.

This chart shows a relatively steady progression of increased issuance in the United States and a similar trend in Europe over the past four quarters. While first quarter 2013 U.S. issuance was down slightly, sequentially the mix was much more favorable with a 31% increase in high yield and a 16% decrease in investment grade. In addition, U.S. structured issuance increased in the quarter, driven by upbeat collateralized loan obligation, or CLO, and commercial mortgage-backed securities, or CMBS, issuance. This is promising as securitization is a great sign that capital is being deployed into the economy creating growth, consumer demand and some of the jobs that we're all looking at.

We are cautiously watching the CLO market to see if this growth will persist. We also are focusing in on if it was merely a rush to get issuance to market before the final FDIC rules take effect that could require banks to incur higher deposit insurance premiums for their holdings of CLOs. We'll see more of that as we go forward.

As for the CMBS market, improving economic conditions, stabilizing delinquency rates, and tighter spreads have increased attractiveness of this market. In Europe, covered bond issuance decreased 51% as a result of credit market weakness, bank deleveraging, and the impact of the ECB's 3-year Long Term Refinancing Operations.

Non-transaction revenue grew 9% and was driven primarily by an increase in entity credit ratings as new companies came to market. Transaction revenue grew 36% and was driven primarily by increased issuance of high-yield corporates, CMBS, CLOs, as well as bank loan ratings.

At this point, let me give you a look at the litigation picture and an update. As you know, there has been considerable activity on several fronts recently. With regard to the Abu Dhabi case, a case involving claims related to investments in the Cheyne Structured Investment Vehicle that was set to go to trial in federal court in New York on May 13th, the Company has settled the case.

In addition, the King County case involving claims relating to investments in the Rhinebridge Structured Investment Vehicle has also been settled. As such, we will be disclosing in our Form 10-Q, that the Company has settled these two cases for a total of approximately $77 million. There was no admission of liability or wrongdoing made in connection with any of these settlements.

Separately, on April 22nd the Company responded to the DOJ complaint with a motion to dismiss the entire complaint because corporate statements referring to independence and objectivity are not actionable under federal law, and this was determined by the U.S. Court of Appeals for the Second Circuit, in a case involving the very same statements.

In addition, the complaint does not include facts showing that Standard & Poor's did not believe its CDO (collateralized debt obligation) ratings when it issued them, nor that it had a specific intent to defraud CDO investors.

The Department of Justice now has the opportunity to respond to our motion, and the arguments of both sides will be heard by the judge later in 2013. Additional information is available on all of these situations at www.standardandpoors.com/response.

In handling the State Attorneys General actions, the Company removed all of the State Attorneys General actions (except California) from state to federal court and asked the federal panel on multidistrict litigation, known as JPML, to transfer them before a single federal court for all pretrial proceedings.

- Oral argument has been scheduled by the JPML to be held on May 30th.
- Seven State Attorneys General cases have been stayed, pending the decision by the JPML on our motion for consolidation. The Company has filed motions asking courts in other states to do the same.
- In North Carolina, the federal court has denied the stay motion but has not remanded the case to state court.
- And a federal court has granted the Connecticut State Attorney General's remand motion.

And finally we have a solid track record of defending the Company and will continue to do so—and aggressively. You can see the details of this track record on this slide. We continue to believe we have strong factual and legal defenses in all pending litigations.

S&P Dow Jones Indices

Let me now review our S&P Dow Jones Indices business.

In the first quarter, organic revenue increased 9% to $86 million and the addition of the Dow Jones index revenue brought total revenue to $115 million. The principal driver of the organic revenue growth was a 26% increase in assets under management in exchange-traded funds linked to S&P indices which reached more than $450 billion. Including the assets under management linked to Dow Jones indexes, assets under management surpassed one-half trillion dollars for the first time – reaching $525 billion at the end of the quarter.

Trading volume of exchange-traded derivatives increased double digits led by higher daily contract volumes at the Chicago Board Options Exchange for S&P 500 index options and the CBOE Volatility Index, commonly known as the VIX. Revenue declines in mutual funds and modest data subscription growth tempered revenue growth.

While the joint venture realized $67 million of adjusted operating profit, $49 million is retained by our Company as 27% of the profits are forwarded to our partners.
The world's first and largest exchange-traded fund, the SPDR S&P 500, trading with the symbol SPY, reached its 20th anniversary—quite a milestone. Launched in January 1993 with just $6.5 million in assets, the SPDR S&P 500 exchange-traded fund is now the world's largest exchange-traded fund with more than $130 billion in assets under management and the most traded exchange-traded fund with

an average daily volume of 144 million shares providing outstanding liquidity to institutional investors.

We see great value in forming partnerships with companies that can help us broaden our reach, our scope, our scale. The S&P Dow Jones Indices joint venture is a great example. We are pleased that after only nine months since its formation, the integration of the two companies is substantially complete.

Another partner is the CBOE, a firm which recently celebrated its 40th anniversary. We recently amended our license agreement with them to extend exclusive rights to certain security options such as the SPX, the most active U.S. index option, as well as the VIX to 2032.

And finally, we entered into a new partnership with the oldest exchange in Asia, the 136-year-old Bombay Stock Exchange, commonly referred to as BSE, to calculate, disseminate, and license the widely followed suite of BSE indices. The partnership brings together BSE's closely watched India index suite, which includes the SENSEX, with S&P Dow Jones Indices' 115 years of experience in publishing uncompromised global benchmarks. Few partnerships bring together over 250 years of experience.

S&P Capital IQ

Now, let's move on to S&P Capital IQ.

In the first quarter, this business delivered top-line growth of 5%, of which 3% was organic. Two key offerings, S&P Capital IQ Desktop Solutions and RatingsXpress, led the revenue growth. These results were offset somewhat by declines in revenue from Equity Research.

S&P Capital IQ Desktop Solutions had a 10% increase in its number of users and RatingXpress delivered high single-digit subscriber growth. Last quarter we told you that RatingsXpress is now available on Xpressfeed. This has been well received and we are winning new business due to the upgraded Xpressfeed platform.

Operating profit decreased 9% and there was a decline in the operating margin as the segment integrates and develops newly acquired technology and products from R^2, QuantHouse, and CMA into various new product offerings.

I would like to briefly preview three new capabilities launched this past quarter:

- S&P Capital IQ is known for the breadth and depth of its data. We extended this capability with the launch of proprietary fundamental data for roughly 260,000 additional privately-held Western European companies, bringing global coverage to 500,000. The data is as complete as public-company data and includes industry classifications. So for example, when a client executes a data search the answer will be populated with both public- and private-company information.
- Leveraging the capabilities we acquired with QuantHouse, we launched a consolidated real-time data feed to compete in this $2 billion real-time market. This new capability addresses industry demand for differentiated, low-latency data at different speeds.
- Further leveraging the QuantHouse acquisition, we launched the Alpha Factor Library. Built from the industry's first Global Point-In-Time database, the Alpha Factor Library is an advanced Web-based market analysis and research tool that is updated daily to provide statistical profiles, definitions, and ongoing performance for hundreds of quantitative stock-selection signals.

Commodities & Commercial Markets

With that, now let me turn to the Commodities & Commercial Markets segment.

Revenue grew slightly in the first quarter at 1%. Operating profit decreased 2%, resulting in a 90 basis-point decrease in the operating margin.

Platts continued to deliver steady growth with a 10% increase in revenue. This growth was primarily the result of growth in petroleum subscriptions. In addition, royalty revenue from petroleum derivative trading increased more than 25% and petrochemical product subscription delivered high single-digit growth. In an effort to improve our product offering, Platts is upgrading its price reporting capabilities by creating a system that will better handle compliance needs and include new real-time news capabilities.

In the global commodities markets, continued volatility has increased demand for transparency. That is exactly why Platts introduced its electronic editorial platform to facilitate price discovery in the iron ore spot market. Platts is helping to facilitate transparency and efficiency by clearly showing the bids, offers, and other information in the iron ore market. The information collected from Platts Editorial Window, or eWindow, has further enhanced the speed and efficiency of the Platts' price assessment process, helping to transform the iron ore market from a long-term annual pricing system to a flexible spot market.

Commercial Markets' revenue decreased 8% in the first quarter. J.D. Power faced a difficult comparison to record results in the first quarter of 2012, as well as reduced licensing from recent award recipients. However, there was some offset at J.D. Power with revenue growth in China. McGraw Hill Construction declined as difficult market conditions have continued to impact revenue there.

On more promising notes, J.D. Power continues to grow its business in Asia and now derives approximately 30% of its revenue from Asia. Also, McGraw Hill Construction launched three new products Dodge BidPro, Dodge BuildShare, and Dodge SpecShare within the last two years. These products now represent 18% of McGraw Hill Construction's annualized contract value.

That concludes my review of the Company's results in the first quarter. As we started off and as we were saying, we have a new name, a new ticker, and a new brand identity. Yet our history of integrity and ingenuity perseveres. For 125 years the common thread of our Company has been the integrity and ingenuity of our employees. From the Industrial Revolution to today, they have delivered essential intelligence that customers and markets can trust.

As we look ahead, our long-term growth prospects are excellent because of the people, culture, and capabilities of this company— and the powerful enduring trends in our markets.

With that, now let me to turn the call over to Jack Callahan, our chief financial officer, for additional detail on the financials. Then we'll be back for any questions or comments that you may have.

Jack Callahan
Executive Vice President and CFO
McGraw Hill Financial

Thank you, Terry. And good morning to everyone joining us on the call.

This morning I want to briefly discuss several items on our performance and outlook for 2013:

- First, I want to recap key financial metrics in the quarter;
- Second I will detail the one-time costs that were incurred during the quarter; and
- Lastly, I will provide some additional detail related to the balance sheet and our 2013 free cash flow guidance.

As Terry just discussed, in the first quarter of our first year as McGraw Hill Financial, we are off to a terrific start.

Revenue grew 14% to $1.18 billion, and adjusted operating profit grew 28%, driven primarily by the strong results in Standard & Poor's Ratings Services, the impact of the S&P Dow Jones Indices joint venture, and the benefits realized from our cost reduction initiatives. For example, adjusted unallocated expense decreased 2% in part due to our recent cost reduction efforts. As a reminder, these unallocated expenses include approximately $20 million to $25 million of stranded costs due to the divestiture of McGraw-Hill Education. Overall, the margin expansion was significant as consolidated operating profit margins increased almost 4 points to approaching 34%.

The tax rate declined 250 basis points to 35% while non-controlling interests grew $16 million, both primarily due to the impact of the S&P Dow Jones joint venture. The tax rate also benefited from certain ongoing tax planning activities.

Adjusted net income from continuing operations and adjusted diluted earnings per share both grew 29%. The share count of 284 million shares did not change materially as the 5.9 million shares repurchased in 2012 were largely offset by record stock option exercises last year. All in all, a strong start to the year.

Now, let me just take a moment to run through the one-time costs we have excluded from adjusted earnings:

- McGraw Hill Financial incurred $44 million in one-time Growth and Value Plan costs related to the separation activities of McGraw-Hill Education. These expenses primarily involved a shift to a new payroll provider, the closure of a data center, and the separation of a human resource service center. Note that approximately one half of these costs were non-cash.
- Over the balance of the year, we anticipate that the remaining Growth and Value Plan cash costs will be approximately $20 million to $25 million. All in all, the one-time costs in separation are winding down.
- In addition, the Company incurred approximately $77 million of legal settlement costs associated with the Abu Dhabi and King County cases. While the costs were reflected in the first quarter income statement, they will not appear in the cash flow statement until the second quarter.

Now, I want to provide detail on several large cash-related items that occurred during the first quarter. Upon closing the sale of McGraw-Hill Education, we received net proceeds of $2.2 billion. This includes gross proceeds of $2.4 billion, less approximately $200 million of closing adjustments primarily related to working capital true-ups. Since there was a sizeable gain on the sale, approximately $300 million of taxes are due, but have not yet been paid. In total, net proceeds were approximately $1.9 billion, which is consistent with the estimates we provided previously.

Upon receipt of the cash we immediately took two transactions. First, we repaid approximately $450 million of commercial paper that was originally issued in the fourth quarter to fund the $700 million special dividend. Secondly, we entered into a $500 million accelerated share repurchase transaction.

As of the end of the quarter, we had an exceptional balance sheet with $1.9 billion of cash and only $800 million of long-term debt. Our overall debt is now reduced by one third. We intend to maintain a strong balance sheet going forward to both build the business and, as appropriate, return cash to shareholders.

I do want to review the impact of the accelerated share repurchase transaction (ASR). As it was executed in late March, the shares received had little impact on shares outstanding during the first quarter. The transaction will reduce diluted average shares outstanding in the second quarter by approximately 8.6 million shares. In addition, when the ASR is concluded, we will receive a modest number of additional shares. Fully diluted share count in the second quarter should be approximately 276 million shares although it could be impacted a bit by ongoing option exercise activity.

Now I want to provide additional detail to clarify our 2013 free cash flow guidance. There were three key items that, due to their timing, will reduce 2013 free cash flow:

- First, while we took numerous Growth and Value Plan restructuring charges in 2012, not all of the cash was paid out in 2012. We estimate that approximately $100 million will be paid out during 2013.
- Second, because of Hurricane Sandy, the IRS allowed fourth-quarter estimated tax payments that are normally made in December to be paid in February. This payment was approximately $130 million and was paid in the first quarter.
- Third, incentive compensation is expensed in the current year and paid out in March of the following year. Since 2012 performance was well above 2011, the cash paid out in March 2013 was approximately $70 million greater than 2012. Again, these incentive payments were made in the first quarter.

Collectively, these three items reduced our 2013 free cash flow by approximately $300 million. After the impact of these items, our operating cash flow guidance remains $650 million to $700 million.

Summing up, we are off to a solid start to the year. We are maintaining our existing earnings per share guidance of $3.10 to $3.20 despite the loss of interest income as a result of the elimination of the $250 million 8.5% note from the sale of McGraw-Hill Education which was included in our initial outlook. Let me remind you that the overlaps over the balance of the year become increasingly more difficult due to a very strong second half of 2012.

Overall, we anticipate solid top- and bottom-line growth for the full year. Our balance sheet is exceptional and continues to provide us with considerable flexibility to enhance the value of McGraw Hill Financial going forward.

The first year of McGraw Hill Financial looks promising. With that, now let me turn the call back over to Terry.

Harold McGraw III
Chairman, President and CEO
McGraw Hill Financial

Thanks, Jack, and again, we are obviously pleased with the start of 2013 and the first-quarter earnings. With revenues up 14% and EPS from continuing operations up 29% to $0.80, we are very pleased with how the businesses are performing; and we're making also very considerable progress on the legal front.

To access the accompanying slides online, go to:
http://investor.mhfi.com/phoenix.zhtml?c=96562&p=irol-EventDetails&EventId=4940393

- the volatility of the energy marketplace;
- and the contract value of public works, manufacturing and single-family unit construction.

We caution readers not to place undue reliance on forward-looking statements.