McGraw Hill Financial
3rd Quarter 2013 Earnings Conference Call
Prepared Remarks
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Chip Merritt
Vice President, Investor Relations
McGraw Hill Financial

Good morning. Thank you for joining us this morning for McGraw Hill Financials' third quarter 2013 earnings call. Presenting on this morning's call are Harold McGraw III, Chairman, President and CEO; Doug Peterson, President and CEO Designate; 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.mhfi.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.

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.

I would also like to call your attention to a new European regulation. Any investor who has, or expects to obtain, ownership of 5% or more of McGraw Hill Financial should give me a call to better understand the impact of this legislation on the investor, and potentially the Company.

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.

At this time I would like to turn the call over to Harold McGraw III, Terry.

Harold McGraw III
Chairman, President and CEO
McGraw Hill Financial

Thanks, Chip and good morning everyone.

Let me quickly begin this morning by saying just how pleased we all are with the effort and the care that Chip Merritt demonstrates each and every day and for those of you who have followed us for quite some time, you will remember the great Don Rubin. Well, Chip is in that category now and that's pretty high praise. So thanks for all that you are doing, Chip. And again, thanks for all of you for being with us this morning and welcome to today's conference call.

I would like to begin this call by summarizing the highlights we will cover today.

- First and very importantly, after a very successful transition, Doug Peterson will become President and CEO on November 1.
- We increased our investment in CRISIL, India's largest ratings agency, and that is up to 67.8%—a fine use of some of our ex-U.S. cash.
- The sale of Aviation Week was completed.
- We delivered several records during the third quarter:
  - Both S&P Capital IQ and S&P Dow Jones Indices delivered record quarterly revenue
  - And Commodities & Commercial Markets reported a record adjusted operating margin
- Despite difficult comparisons and lower issuance than the third quarter last year, Standard & Poor's Ratings Services grew its revenue 8% and its adjusted operating profit by 5%.
- The Company repurchased 5.7 million shares during the quarter bringing the year-to-date total to 15 million shares.
- We reported 13% diluted adjusted EPS growth despite challenging year-over-year debt issuance comparisons.
- And lastly, as part of Jack Callahan's financial discussion we will share our newly increased 2013 EPS guidance. Guidance that has now been increased two quarters in a row.

We recently launched a brand awareness advertising campaign. The purpose is to generate greater awareness among customers, the financial community, regulators, and the media about the McGraw Hill Financial brand. The primary message is that we have combined the leading brands in ratings, benchmarks, and analytics to become the world's foremost provider of financial intelligence. This is an example of one of the posters. COMBINED WE ARE is the theme that permeates this campaign.

Now let's turn to the financial performance during the third quarter:
- Revenue increased 7%,
- Adjusted operating margin increased 130 basis points to 33.2%, and
- Diluted adjusted EPS grew 13%.
- S&P Dow Jones Indices delivered the strongest revenue growth.
- Both Commodities & Commercial Markets and S&P Dow Jones Indices delivered the greatest adjusted operating profit growth of 24% and 23%, respectively.
- A reduction in shares outstanding from our continuing share repurchases also contributed to the EPS increase.

These two pie charts should help put into perspective the revenue and operating earnings contribution of each of our business segments. Each of our segments is a major contributor to both revenue and operating profit.

We like to keep you current on various litigation matters but there is not a great deal new to report at this time.

- Thirty three cases have been dismissed outright, and that's no change from last quarter.
- Two additional dismissals by lower courts have been affirmed by higher courts bringing the total to 13 dismissals and 10 cases have been voluntarily withdrawn. That leaves us with just a few dozen non-government cases that remain outstanding.
- Efforts by the plaintiff in the Reese stock-drop litigation to reopen this dismissed case have been denied. And, by the way, in the Court's decision it stated, *"At bottom, the fact remains that plaintiffs have not convinced the Court that it should alter its conclusion that Standard & Poor's statements about the integrity and independence of its ratings are not specific enough to amount to a guarantee that its ratings were made without regard to profits, market share, or client feedback."*
- In the Department of Justice case, we are awaiting a supplemental disclosure from the plaintiff relating to the claims. In the consolidated states case we are awaiting a ruling on the States' motion to remand the case back to the states.
- Only one new case, the New Jersey state case, has been filed since the second-quarter earnings call.

S&P Dow Jones Indices

With that, let me turn to the individual businesses. I'll start with S&P Dow Jones Indices.

Beginning this quarter all data is now comparable as we have lapped the anniversary of the joint venture formation. In the third quarter, revenue increased 14% to a quarterly record of $124 million. The principal driver of the revenue growth was a 29% increase in quarter-ending assets under management in exchange-traded funds linked to our indices which reached more than $585 billion.

The continued rise in equity prices of approximately 14% and strong fund inflows of approximately 13% drove the third consecutive quarterly record for assets under management in exchange-traded funds linked to the S&P Dow Jones Indices. It is important to note that the revenue impact is not as pronounced as the growth in assets under management as the basis points charged are not always linear with asset growth.

With equity prices near record levels, investors increasingly utilized derivatives that are based upon our indices such as the S&P 500 index options (or SPX) and the CBOE Volatility Index (or VIX) to hedge their positions. Volume at the Chicago Board Options Exchange for the SPX and VIX increased 18% and 26%, respectively, during the quarter.

While the joint venture realized $80 million of adjusted operating profit, $58 million is retained by the Company as 27% of the profit is forwarded to our partner, the CME. What is truly remarkable is that the entire incremental revenue of $15 million dropped to operating profit. That is a testimony to what a fabulous, fabulous business this is.

During the third quarter, we created 26 new indices and 10 new exchange-traded funds based on our indices that were launched. These new indices help us continue to diversify and grow this important business.

S&P Capital IQ
With that, let me now move on to S&P Capital IQ.

In the third quarter, this business delivered quarterly revenue with top-line growth of 3%. Excluding the lost revenue from ongoing portfolio rationalization of several small products, organic growth was approximately 5%. This was the highest quarterly revenue for this segment. Adjusted operating profit returned to growth with an increase of 10%.

Last quarter we highlighted the four key categories that make up the segment. Three of these, Desktop Solutions, Enterprise Solutions, and Ratings IP delivered mid single-digit revenue growth while the fourth, Proprietary Research reported a mid single-digit decline in revenue.

While we have made meaningful investments in S&P Capital IQ over the last year, we have also continued to fine-tune the portfolio. Most recently we completed the sale of Financial Communications, and are exploring options for Funds Management Research Europe, or FMR Europe, an independent, qualitative research service that provides assessments of fund manager investment process and operational consistency. We expect that as the portfolio progresses this will become a higher margin, faster growing business segment.

We like to highlight new product launches whenever we can and Capital IQ had yet another. During the quarter, Enterprise Solutions leveraged QuantHouse technology to create Event Driven Alerts.

Event Driven Alerts is a new offering that delivers S&P Capital IQ's most valuable indicators in a low latency, machine-readable data feed. These alerts contain credit rating actions including upgrades/downgrades, credit watch announcements, and credit outlook changes. While this is not likely to be a major revenue generator, we cite this today as an example of how S&P Capital IQ worked with Standard & Poor's Ratings Services to leverage new technology to create this offering.

We will see even more of this kind of collaboration and coordination across business units in the time periods ahead. We are very proud of this. We call it the Power of One, working together smart and focused.

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

Revenue grew 7% in the third quarter. Excluding the impact of the sale of Aviation Week, which closed on August 1, organic revenue increased 10%. Platts delivered double-digit revenue growth while mid single-digit growth at J.D. Power offset softness at McGraw Hill Construction.

Adjusted operating profit increased 24%, resulting in record adjusted operating margin of 32.3%. Similar to our index business, the conversion of revenue to operating margin was remarkable. Here, $16 million of incremental revenue resulted in $15 million of incremental operating profit.

In Commodities, Platts recorded a 17% increase in revenue. Growth in petroleum product subscriptions continued to be the primary driver of this double-digit growth. In addition, licensing revenue from petroleum derivative trading increased more than 90% as volatile oil prices increased trading activity. Metals & Agriculture product subscriptions delivered double-digit revenue growth while Petrochemicals and Power & Gas revenue reported single-digit revenue increases.

Building on our recent acquisition of Kingsman, Platts launched "Platts Market Data — Sugar", a user-friendly means of receiving the latest and historical sugar price assessments from Platts/Kingsman. It provides prices for all of the main sugar markets worldwide, with over 30 Kingsman price assessments and over 30 third-party assessments published daily for the most commonly traded grades and locations.

While sugar has been the latest commodity we have been developing, in June of 2011 we moved more deeply into the iron ore market with the acquisition of Steel Business Briefing.

Historically, iron ore prices were established during annual negotiations among the world's largest iron ore miners and steel producers. By 2008, large gaps had emerged between spot market prices and the annual contracts. This volatility created the need for benchmarks from an independent pricing agency. Much of the world's iron ore is now based upon Platts' benchmark pricing and we're very proud of that.

The need for benchmark pricing has evolved from physical prices to derivative prices as market participants have a need to hedge their positions. This chart depicts monthly iron ore derivative activity. And, I might add, more than 99% of the activity settles against The Steel Index, one of our primary iron ore benchmarks.

There is a great article that describes the changes to the iron ore market that have taken place and the link to that article is at the bottom of this slide. I hope you have a chance to take a look at it. We think that the evolution of pricing that has taken place in iron ore is instructive for other commodities as well.

Commercial Markets' revenue decreased 4% in the third quarter. Excluding the sale of Aviation Week organic growth was 1%.

We anticipate that McGraw Hill Construction's revenue decline may be nearing an end as new data and analytics products along with an increase in U.S. commercial construction starts bode well for the business. Historically we have not spent much time discussing the McGraw Hill Construction business so I thought today that I'd take a few moments to do exactly just that.

According to economic research from Standard & Poor's Ratings Services, the U.S. commercial real estate sector continues to slowly recover from its worst slump obviously in decades. Construction starts in the commercial sector are on track to jump 15% this year. And while there is a long way to go to make up for the 58% plunge from 2007 - 2010, when the country was mired in the Great Recession, the recent increase is very encouraging.

During the recession, the McGraw Hill Construction streamlined its operations, eliminated low-margin legacy print products and publishing assets — gaining operational efficiencies without sacrificing quality. At the same time, the business invested in its Dodge analytics business to be solidly positioned for a market rebound. This investment produced new database-driven analytic products like Dodge SpecShare, MarketShare, and BuildShare that support the business's premium market position. Today, approximately 75% of the revenue of the business is from data and analytics, very similar to the rest of the Company.

Simultaneously, the business took the difficult steps to dramatically reduce costs. In fact, its contribution to earnings has improved as decreases in costs have outpaced the rebalancing of the portfolio.

Shifting now to J.D. Power, the auto business in China and the telecommunications business in Canada delivered the strongest revenue growth. Economic growth and growing consumer demand have led to the rapid expansion of a domestic Chinese automotive industry and, consequently, strong demand for J.D. Power's analysis and insights into consumer preferences and behaviors.

This chart shows global light vehicle sales from 2006 to projected 2020. The most telling data on this chart is that approximately one half of the growth is expected to come from China. J.D. Power is well positioned in China to participate in this growth.

That concludes a relatively quick review of the business units and their achievements in the quarter and were very proud of those. We mentioned a little bit of the results in terms of the S&P Rating Services but let me turn that over to get a little bit more detail from Doug Peterson. And as I previously mentioned, we are all very pleased and thrilled to be introducing Doug Peterson not only as President of Standard & Poor's Rating Services but as our next President and CEO as of November 1.

So with that, Doug, over to you.

Doug Peterson
President and CEO Designate
McGraw Hill Financial

Thank you, Terry.

We noted on our last earnings call, that comparisons for the Standard & Poor's Ratings Services segment would become much more difficult in the second half of 2013 and you can see that in the reported numbers.

- Revenue for the segment grew 8%,
- Adjusted operating profit increased 5%, and
- The corresponding adjusted operating margin decreased 120 basis points to 42%. While third quarter expenses decreased sequentially, year-over-year they increased approximately 10% primarily due to technology-related investments, as well as modest increases in marketing and compliance expenditures. However, headcount remained relatively unchanged year-over-year.

We were able to increase both revenue and profit despite issuance that actually decreased year-over-year. The increase in revenue was not driven by issuance but rather by increased bank loan ratings, entity credit ratings, and rating evaluation services.

Bank loan ratings were particularly strong, increasing 73% driven by a tripling in Europe primarily as a result of the refinancing of existing bridge loans, maturing debt, and recapitalization.

In the near term, we expect the levels of issuance to be impacted by the continuing market reaction to the U.S. debt ceiling debate, Federal Reserve tapering, and interest rate levels overall.

You will see that non-transaction revenue grew 9%, driven by increased entity credit ratings and rating evaluation services. Despite a decrease in issuance, transaction revenue increased 6% as a result of a 73% increase in bank loan ratings. As you see in the table, international gains exceeded domestic gains. This was driven by 16% growth in our European revenues, driven primarily by corporate activity despite a drop in corporate issuance overall.

These charts also show third quarter year-over-year issuance decreases in both the United States and Europe of 3% and 18%, respectively. In the U.S., corporate issuance was flat and public issuance was down 19% as municipal issuers shied away from the markets after Detroit's bankruptcy. Structured issuance was strong in CMBS (+47%), RMBS (+26%) and CDOs (predominately CLOs +88%)—albeit all of these were off smaller bases. These offset the weakness in the larger ABS market which dropped 14% overall.

In Europe, corporate issuance decreased 20% but high-yield issuance increased 82%. This was due to record-low spreads and diversification of funding from banks. Structured issuance decreased 9% due primarily to the ECB's Long-Term Refinancing Offering, known as the LTRO, and its impact on covered bonds.

Since this will be Terry's last earnings conference call, we thought it only appropriate to highlight a few of the major accomplishments that have taken place under his leadership. Terry became CEO on April 29, 1998. In his first letter to shareholders he wrote, "Our commitment to our shareholders is to increase shareholder value by serving our markets aggressively and ethically and, like our customers, striving to reach our full potential."

Since 1998 the Company has:

- Delivered a total return of approximately 300% versus only 97% for the S&P 500.
- Returned more than $13 billion to shareholders through dividends and share repurchases.
- Continued yearly increases to a dividend that began in 1937 and has been increased every single year since 1973.

But more importantly, under Terry's leadership he has transformed the Company. In 1998, the Company was predominately a collection of publishing assets. Financial Services represented only 31% of the $3.7 billion in annual revenue and the operating margin was 18.5%.

During the last 15 years, the Company has divested the publishing assets to others who can make the most with those businesses. It has also reshaped the Financial Services segment into the leading portfolio of brands that we have today.

- A portfolio with an adjusted operating margin that has more than doubled since 1998.
- A portfolio that provides essential intelligence through leading ratings, benchmarks, and analytics to its customers.

While Terry is stepping down as President and CEO, he will remain Chairman of the Board providing his guidance and insights to me and the rest of the management team.

Now I would like to turn the call back over to Terry, and thank you all.

Harold McGraw III
Chairman, President and CEO
McGraw Hill Financial

Doug, thank you for the kind words.

The bottom line is very simple, that McGraw Hill Financial is a very, very special place with very special people who are dedicated to making a very positive impact in the markets that we serve. Clearly, as Chairman of the Board, I look forward to continuing to work with Doug and the management team and the rest of the Board to continue to build this great Company.

So with that, let me turn the call over to Jack Callahan, our Chief Financial Officer, for additional details on the third quarter, full year, and on our financials. Jack?

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 the balance of 2013:

- First, I want to recap key financial results in the quarter.
- Second, I will review recent changes to the portfolio and the associated one-time items, largely gains, that were incurred during the quarter.
- Third, I will provide updates on the balance sheet, year-to-date free cash flow, and share repurchase activity.
- And finally, I will comment on the increase to our 2013 EPS guidance.

As expected, third quarter comparisons proved more challenging than the first half, but we were able to deliver another solid quarter of growth.

- Revenue grew 7% to $1.19 billion, with organic revenue growing 8% excluding the sale of Aviation Week and product closures at S&P Capital IQ.
- Adjusted segment operating profit grew 11%, driven primarily by the strong results at S&P Dow Jones Indices and Commodities & Commercial Markets. In addition, I would note that S&P Capital IQ returned to profit growth in the quarter.
- Adjusted unallocated expense increased 10% primarily due to an increase in excess office space.
- Overall, the margin expansion was significant as the consolidated adjusted operating profit margin increased 130 basis points to 33.2%, despite a modest decline in year-on-year margin performance in S&P Ratings, our largest and most profitable business unit.
- The tax rate came in at our guidance level of 35%. This was an increase of 160 basis points from the third quarter of 2012. The third quarter a year ago was low due to the impact of the S&P Dow Jones Indices joint venture that was created that quarter.
- Adjusted net income from continuing operations increased 11%.
- The impact of the share repurchase program can be seen in relatively faster growth in adjusted diluted earnings per share at 13% as average diluted shares outstanding declined approximately 2% to 278.8 million shares; the ending basic share count was 270.6 million, down 2.5%.

Overall, another strong quarter demonstrating the strength and breadth of our portfolio.

There were a number of changes to our portfolio during the quarter:

- As Terry mentioned, the Company invested $214 million to increase its ownership of CRISIL from approximately 53% to 68%. CRISIL has earned approximately $185 million in revenue during the last 12 months. It has a leading position in India, a broad product line serving global customers, and an essential partner in working closely with the Standard & Poor's Ratings business. Our previous CRISIL investments have delivered tremendous returns and we were pleased to be able to increase our ownership even further.
- S&P Dow Jones Indices and the Bombay Stock Exchange completed the formation of Asia Index Pvt. Ltd., a 50-50 joint venture. It is hoped the new company will raise the profile of the SENSEX and other S&P BSE indices as S&P Dow Jones Indices looks to further extend its South Asia growth.
- During the quarter the Company also divested Aviation Week and Financial Communications. Financial Communications is a small, non-core asset that was within S&P Capital IQ segment
- CRISIL also exited its equity investment in India Index Services & Products Ltd.

As a result, there were a number of one-time items that need to be adjusted to better evaluate the ongoing performance of the business. In our adjusted earnings, we are excluding:

- a $16 million gain on the sale of India Index Services,
- an $11 million gain on the sale of Aviation Week, and
- a $3 million loss on the sale of Financial Communications.
- We are also excluding $10 million of Growth and Value Plan costs, which have largely wound down. There were also some limited restructuring actions.

In total, we excluded a net gain of $11 million.

We continue to maintain an exceptionally strong balance sheet. As of the end of the quarter, we had $1.6 billion of cash and approximately $800 million of long-term debt.

Going forward, this strong balance sheet positions us to continue to make investments like CRISIL that are targeted at building the business and, as appropriate, sustaining our share repurchase program.

Our free cash flow during the first nine months of 2013 was $388 million. As we discussed previously, there were two large items that have negatively impacted year-to-date results:

- First, because of Hurricane Sandy, the IRS allowed fourth-quarter estimated tax payments that are normally paid in December to be paid in February. This payment was approximately $130 million and was paid in the first quarter.
- The second item was the $77 million payment associated with the legal settlement that was also included in our first quarter 2013 results.

Including the impact of these items, our free cash flow guidance remains $650 million to $700 million for the full year.

Now, let me update you on our share repurchase activity:

- During the third quarter, approximately 5.7 million shares were repurchased.
- So far in 2013, we have spent $850 million and have repurchased 15 million shares at an average price of $56.70.
- Approximately 1.9 million shares remain under our existing share repurchase authorization and we anticipate completing this authorization before the end of the year. Of note, this 50 million share authorization was approved by the Board of Directors in mid-2011.

So summing up:

- We have delivered excellent year-to-date results with 12% revenue growth and 24% adjusted diluted earnings per share growth.
- And we continue to fine-tune the product portfolio as evidenced by activity during the quarter.
- Looking forward, we know that year-on-year comparisons in the fourth quarter will be challenging, particularly for Standard & Poor's Ratings Services, and, as we have seen in the last few weeks, markets remain somewhat volatile.
- Never-the-less, we are on pace for strong full-year results and are raising our 2013 adjusted diluted earnings per share guidance from a range of $3.15 to $3.25 per share to $3.25 to $3.30 per share—up $0.05 on the high end of the range.

So now with three quarters of the year in, we are on pace for a terrific first year for McGraw Hill Financial and today we've delivered a great last quarter for Terry McGraw as President and CEO.

With that, let me now turn the call back over to Terry.

Harold McGraw III
Chairman, President and CEO
McGraw Hill Financial

Thanks, Jack, and again, we are well on our way to delivering excellent 2013 results. And as Jack said, we have raised our EPS guidance for the second time in as many quarters and are harnessing the earnings power of our leading brands by providing essential intelligence to our customers and we are obviously very proud of this record and a lot more to come.

Thank you all for being with us on the call. And now, let me turn it back to Chip Merritt who will provide instructions for the Question & Answer session.

To access the accompanying slides online, go to:
http://investor.mhfi.com/phoenix.zhtml?c=96562&p=irol-EventDetails&EventId=5031496

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Forward-looking statements can be identified by the use of words such as “believe,” “expect,” “plan,” “estimate,” “project,” “target,” “anticipate,” “intend,” “may,” “will,” “continue” and other words of similar meaning in connection with a discussion of future operating or financial performance. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions that are difficult to predict; therefore, actual outcomes and results could differ materially from what is expected or forecasted. These risks and uncertainties include, among others:

- worldwide economic, financial, political and regulatory conditions;
- currency and foreign exchange volatility;
- the effect of competitive products and pricing;
- the level of success of new product development and global expansion;
- the level of future cash flows;
- the levels of capital investments;
- income tax rates;
- restructuring charges;
- the health of debt and equity markets, including credit quality and spreads, the level of liquidity and future debt issuances;
- the level of interest rates and the strength of the capital markets in the U.S. and abroad;
- the demand and market for debt ratings, including collateralized debt obligations, residential and commercial mortgage and asset-backed securities and related asset classes;
- the state of the credit markets and their impact on Standard & Poor’s Ratings and the economy in general;
- the regulatory environment affecting Standard & Poor’s Ratings and our other businesses;
- the likely outcome and impact of litigation and investigations on our operations and financial condition;
- the level of merger and acquisition activity in the U.S. and abroad;
- continued investment by the construction, automotive and computer industries;
- the strength and performance of the domestic and international automotive markets;
- 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.