Getting stronger

Operating and financial review

Rona Fairhead Chief financial officer

We've set ourselves the goal of achieving annual progress on earnings, cash and return on invested capital. We made good progress in tough markets in 2003, and you can see how we performed against each of our measures on the facing page.

2003 overview

In 2003 our sales declined by 4%. Our book businesses performed very strongly but could not make up for the absence of the one-off TSA contract, which contributed some £250m to our sales in 2002, and tough trading conditions for our advertising and technology-related businesses. We mitigated the impact of the £272m sales decline with significant cost reductions, so that operating profit was £3m lower at £490m and profit before tax improved to £410m (£399m in 2002). Our operating margins improved from 11.4% to 12.1%, helping adjusted earnings per share to grow to 32.0p, an increase of 6%.

On a statutory basis, we reported a profit before tax for the year of £152m (a £25m loss in 2002) and generated earnings per share of 6.9p (a loss per share of 13.9p in 2002). Our net borrowings were a further 3% lower, ending the year at £1,361m.

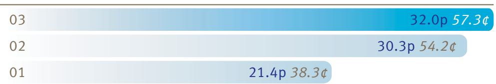
Looking ahead

We are expecting further underlying progress on earnings, cash and returns this year, despite a weak adoption calendar for our school business and investments we are making to support organic growth. Looking further ahead to 2005 and beyond, we expect our performance on all three financial goals to accelerate, with the strengthening of the US School industry, $1bn of contract wins in 2003 and lower costs in our advertising and technology-related businesses.

Earnings, cash and returns are the bedrock of incentive plans throughout Pearson. The annual bonuses of our directors and our senior managers are based either directly on these three measures or on the elements of them which they control. For example, targets for our businesses and managers include underlying sales growth and trading margin – which are key drivers of adjusted earnings per share – as well as cash conversion and working capital – which underpin progress on cash flow and return on invested capital.

Our financial goals

Adjusted earnings per share



The measure We report our adjusted earnings per share (eps) after restructuring charges relating to our continuing businesses. These charges are reported within the operating results of our businesses, and included £20m in 2003 relating to the integration of our book publishing operations in Australia, Canada and the UK.

We exclude from our calculation of adjusted eps the non-cash goodwill charge, costs relating to the integration of major acquisitions and other non operating items. In 2003, we reported a goodwill charge of £264m (down from £340m in 2002), a non operating gain of £6m and no integration costs. This compares with a non operating loss of £37m and integration costs of £10m in 2002.

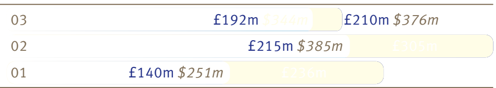
Our progress In 2003 we increased our adjusted eps by 6% (or 11% at constant currency).

In 2004, we expect to show further earnings growth in constant currency as good progress in the FT Group and further cost savings help us to offset the weaker dollar and a slow year for the US School publishing industry.

Looking further ahead, we expect a sharp acceleration in our earnings growth in 2005 and beyond as a rebound in the US School adoption cycle and a potential recovery in our cyclical advertising businesses combine with the cost reductions we've been making for the past three years.

Free cash flow

Total free cash flow Operating free cash flow



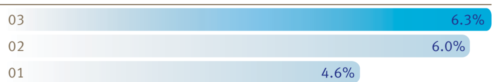
The measure Free cash flow is the measure of the cash that is available from our business operations, after the payment of interest and tax, for distribution to shareholders in the form of dividends or for reinvestment to grow our business. We monitor both operating free cash flow, which measures the cash performance of our businesses, and total free cash flow, which includes tax and finance charges and any non operating items.

We exclude proceeds of disposals and the cost of acquisitions from both these calculations.

Our progress Operating free cash flow was £210m (£305m in 2002) and free cash flow was £192m (£215m in 2002). Two major factors, both timing-related, masked an otherwise strong performance. Penguin's publishing schedule was particularly concentrated in the fourth quarter, pushing collections into 2004, and the TSA has not yet paid some $151m relating to the 2002 contract.

We expect our free cash flow to be ahead in 2004. Looking further ahead, we expect steady progress in cash generation.

Return on invested capital



The measure Return on invested capital is our operating profit less tax expressed as a percentage of gross invested capital. Over the past few years, the transformation of Pearson has significantly increased the capital invested in the business (in the form of goodwill associated with acquisitions) and required substantial cash investment to integrate those acquisitions. With our portfolio largely in the shape we want, our goal is to meet and then exceed our cost of capital which is approximately 7.5%–8.0%.

Our progress Return on invested capital (ROIC) rose from 6.0% in 2002 to 6.3% in 2003. On this measure we were helped by currency movements – stripping out the exchange rate benefit our ROIC would have been 6.1%. We expect ROIC to be the toughest measure to improve in 2004, but expect significant progress in 2005 and 2006.

Note: Adjusted figures are presented as additional measures of business performance. They are stated before goodwill, integration costs and non operating items. Goodwill is amortised over no more than 20 years. Business performance measures are non-GAAP measures for UK reporting. Reconciliations of operating profit, adjusted earnings per share and operating free cash flow to the equivalent statutory heading under UK GAAP are included in notes 2, 9 and 27.