

OPERATING AND FINANCIAL REVIEW

2005 overview

Pearson predicted that 2005 would be a year of strong growth and financial progress, driven by education, our largest business. We have reported that Pearson Education had its best year ever; that the FT Group achieved a further significant profit improvement; and that we see good prospects for continued growth in 2006 and beyond.

Pearson's sales increased 9% in 2005, the fastest rate of growth for five years. Adjusted operating profit increased by 22%, well ahead of sales, with profits improving in all businesses. Operating margin improved by 1.6% points to 12.4%. Adjusted earnings per share were 34.1p, up 24%.

In 2005, Pearson generated more cash than ever before, increasing operating cash flow by £152m or 36% to £570m and free cash flow by £147m or 52% to £431m. Cash conversion was particularly strong at 113% of operating profit. The average working capital to sales ratio at Pearson Education and Penguin improved by a further 2% points to 27.4%, even as we continued to make a significant investment in new products and services that will support our future growth.

Our return on invested capital improved to 6.7%, or 7.2% at constant currency, from 6.2% in 2004.

Our statutory results show an increase in operating profit to £536m (2004: £404m) and in statutory basic earnings per share to 78.2p (2004: 32.9p), benefiting from a £302m profit from Recoletos. We ended the year with net debt of £996m, a £225m reduction on 2004 despite the sharp increase in the value of the US dollar to £1:\$1.72 at 31 December which increased our dollar denominated net debt by £121m.

The £426m proceeds from the sale of our interests in Recoletos and MarketWatch were partially used in a series of bolt-on acquisitions in education and financial information, including AGS, Co-nect and IS.Teledata.

The board is proposing a dividend increase of 6% to 27.0p. Subject to shareholder approval, 2005 will be Pearson's 14th straight year of increasing our dividend above the rate of inflation, and in the past eight years we have returned approximately £1.5bn or one-quarter of our current market value to shareholders through the dividend.



Rona Fairhead, *Chief financial officer*

ADJUSTED EARNINGS PER SHARE

05	34.1p 58.7c
04	27.5p 47.3c
03	27.6p 47.5c

Our progress We increased adjusted earnings per share by 24% on an underlying basis. We expect future strong underlying earnings growth in 2006 as we continue to increase margins and grow ahead of our markets.

FREE CASH FLOW

05	£431M \$741M
04	£284M \$488M
03	£190M \$327M

Our progress Our free cash flow improved by £147m or 52% to £431m, helped by strong operating performance and working capital efficiencies. Although our cash flow benefited from some one-off factors, we expect another good cash performance in 2006.

RETURN ON INVESTED CAPITAL

05	6.7% 7.2%*
04	6.2%
03	6.0%

Our progress Our return on invested capital improved from 6.2% in 2005 to 6.7% or 7.2% at constant currency. We expect a further significant improvement in 2006.

*Constant currency

PEARSON EDUCATION

SALES

05	£2,663M \$4,580M
04	£2,323M \$3,996M
03	£2,422M \$4,166M

ADJUSTED OPERATING PROFIT

05	£348M \$599M
04	£277M \$476M
03	£292M \$502M

School

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	1,295	1,087	19	16
Adjusted operating profit	147	108	36	29

Record results in 2005: Sales up 16% to almost £1.3bn; Profits up 29% to £147m.

Rapid growth in US School publishing, testing and technology

- Pearson's US School publishing business grew 12%, ahead of industry growth of 10.5% (source: Association of American Publishers).
- New adoption market share of 33% where Pearson competed (and 24% of the total new adoption market); leading positions in maths, science, literature and foreign languages.
- School testing sales up more than 20%, benefiting from significant market share gains and first year of mandatory state testing under No Child Left Behind.
- Strong performance in school software, with good sales and profit growth in curriculum and school administration services.

Good progress in international school markets

- High single-digit growth in international school publishing. Worldwide English Language Teaching business benefiting from strong demand for English language learning and investments in new products, including *English Adventure* (with Disney) for the primary school market, *Sky* for secondary schools, *Total English* for adult learners, and *Intelligent Business* (with *The Economist*) for the business market.
- Strong growth in international school testing. Four million UK GCSE, AS and A-Level scripts marked on screen; first year of running UK National Curriculum tests completed successfully; new contract for national school testing pilot in Australia.

Significant efficiency gains and margin improvement

- School margins up by 1.5% points to 11.4% with efficiency gains in central costs, production, distribution and software development.

Continued investment for future growth

- US School new adoption market expected to grow strongly 2007 - 09 (estimated at \$620m in 2006; \$800m in 2007; \$900m in 2008; \$1bn in 2009).
- Steady investment in School publishing: Pearson publishing major new basal curriculum programmes for reading, science and social studies, the three largest adoption disciplines in 2006.
- Healthy outlook in school testing underpinned by 2005 contract wins with a lifetime value of \$700m (including Texas, Virginia, Michigan and Minnesota).
- AGS Publishing, acquired in July 2005, performing ahead of expectations as special needs market grows rapidly and integration is on track.
- Acquisition of Co-nect in December 2005 and creation of Pearson Achievement Solutions targets growing market for teacher professional development and integrated school solutions.

Higher education

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	779	729	7	5
Adjusted operating profit	156	129	21	19

Record results in 2005: Sales up 5% to £779m;
Profits up 19% to £156m.

Above-market growth and significant margin improvement

- US Higher education business up 6%, ahead of industry growth of 5% (source: Association of American Publishers).
- Pearson's US Higher education business has grown faster than the industry for seven straight years.
- Higher education margins up by 2.3% points to 20%. Good margin improvement in US and International publishing, boosted by shared services across US and international units and saving in central costs; technology, production and manufacturing.

Strong publishing performance

- Continued growth from market-leading authors in key academic disciplines including biology (Campbell & Reece), chemistry (Brown & LeMay), sociology (Macionis), marketing (Kotler & Keller), maths (Tobey & Slater), developmental maths (Martin-Gay) and English composition (Faigley's *Penguin Handbook*).
- Rapid expansion in career and workforce education sector, with major publishing initiatives gaining share in allied health, criminal justice, paralegal, homeland security and hospitality.

Rapid growth in online learning and custom publishing

- Approximately 3.6 million US college students studying through one of our online programmes, an increase of 20% on 2004.
- *MyMathLab*, Pearson's innovative online homework and assessment programme, increases unit sales by almost 50% to 1.1 million, with student registrations 47% higher. Usage increases by 60%, with students completing and submitting 11 million assignments online. Research by colleges using *MyMathLab* demonstrates significant improvements in student achievement.
- Continued strong double-digit growth in custom publishing - which builds customised textbooks and online services around the courses of individual faculties or professors.

Good progress in international markets

- 4% sales growth in Higher education publishing outside the US. International businesses benefit from local adaptation of global authors, including Campbell and Kotler, and introduction of custom publishing and online learning capabilities into new markets in Asia and the Middle East.

Continued investment for future growth

- 2006 expected to be a record year for first editions, with major new titles in statistics, algebra, psychology, economics, health and writing.
- Launch of online homework and assessment programmes in new curriculum areas including economics, psychology and developmental writing.
- Creation of Custom Media Solutions Group, extending highly successful customised print publishing model to online curriculum and course management programmes.

Professional

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	589	507	16	15
Adjusted operating profit	45	40	13	13

Sales up 15% to £589m;
Profits up 13% to £45m.

Professional testing: rapid organic growth; Promissor acquisition opens new markets

- Professional testing sales up more than 40%, benefiting from successful start-up of major new contracts including the Driving Standards Agency, National Association of Securities Dealers and the Graduate Management Admissions Council.
- Acquisition of Promissor in January 2006 brings together two leading international professional testing companies and takes Pearson into new US state and federal regulatory markets.

Government Solutions: sales up 38% and \$1bn of new long-term contracts

- Sales up a further 38%, helped by new contracts with the US Department of Education, the Centers for Medicare and Medicaid Services and the London Borough of Southwark. Margins a little lower, resulting from new contract start-up costs.
- More than \$1 billion of new, long-term contract wins for customers including the US Department of Education, Department of Commerce and the University of California.

Professional publishing: margins maintained despite further declines in technology markets

- Worldwide sales of technology-related books 7% lower with continued weakness in professional markets partly offset by consumer technology publishing.
- Pearson maintains leading market share and single-digit margins through further cost actions; sees stronger schedule of new software releases in professional and consumer technology markets in 2006.
- Good growth in business publishing imprints including Wharton School Publishing and Financial Times Prentice Hall. Strong 2006 business list includes new books from *NY Times* bestselling authors Bernard Lewis, Jeffrey Gitomer, Ken Blanchard and Oren Harari.

OPERATING AND FINANCIAL REVIEW CONTINUED
THE FINANCIAL TIMES GROUP

SALES		ADJUSTED OPERATING PROFIT	
05	£629M \$1,082M	05	£101M \$174M
04	£587M \$1,010M	04	£71M \$122M
03	£588M \$1,011M	03	£41M \$71M

FT Publishing

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	332	318	4	4
Adjusted operating profit	21	4	–	–

Profits up by £17m on £14m sales improvement

Advertising growth continues and Financial Times returns to profit

- FT newspaper sales up 6% to £221m; £14m profit improvement to £2m.
- FT advertising revenues up 9% (and up 18% in the fourth quarter), improving through the year. Sustained growth in luxury goods and worldwide display advertising. FT.com advertising revenues up 27% as FT's biggest advertisers shift to integrated print and online campaigns.
- More than 90% of advertising revenue improvement converted to profit in 2005.
- FT's average worldwide circulation 2% lower for the year at 426,453 but 1% higher in the second half at 430,635. FT.com's paying subscribers up 12% to 84,000 and average monthly audience up 7% to 3.2 million.

Sustained progress at network of business newspapers

- Sales broadly level and profits £3m higher at the FT Group's other business newspapers and magazines.
- *Les Echos* advertising revenues and circulation level with 2004 (average circulation of 119,000) despite tough trading conditions.
- FT Business improves margins and profits with good growth in international finance titles.
- *FT Deutschland* reduces losses further despite a weak advertising market in Germany, and increases average circulation by 6% to 102,000.
- *The Economist*, in which Pearson owns a 50% stake, increases its circulation by 10% to 1,038,519 (for the January - June ABC period).

Interactive Data Corporation (NYSE: IDC)

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	297	269	10	7
Adjusted operating profit	80	67	19	13

Record results in 2005: Sales up 7% to £297m;
Profits up 13% to £80m;
Margins up 2% points to 26.9%.

Strong organic growth and operating improvements

- FT Interactive Data, IDC's largest business (approximately two-thirds of IDC revenues), generates strong growth in North America and returns to growth in Europe.
- Modest growth at Comstock, IDC's real-time datafeed business for global financial institutions, and at CMS BondEdge, its fixed income analytics business.
- Renewal rates for IDC's institutional businesses remain at around 95%.
- eSignal, IDC's active trader services business, increases headline sales by 27% with continued growth of subscriber base and full-year contribution from FutureSource, acquired in September 2004.
- Continued progress in transition to two new consolidated data centres, enabling IDC's four major businesses increasingly to feed off one centralised data and technology infrastructure.

Continued expansion into adjacent markets

- Acquisition of IS.Teledata for \$51m (net of cash acquired) in December 2005 adds web-based financial data applications and further expands IDC's presence in continental Europe.
- Agreement to acquire Quote.com and related assets for \$30m in February 2006 which will broaden IDC's range of online services for active traders and financial professionals, and create a new revenue stream in online financial advertising.

THE PENGUIN GROUP

SALES		ADJUSTED OPERATING PROFIT	
05	£804M \$1,383M	05	£60M \$102M
04	£786M \$1,351M	04	£52M \$90M
03	£840M \$1,445M	03	£83M \$143M

	2005 £m	2004 £m	Headline growth %	Underlying growth %
Sales	804	786	2	1
Adjusted operating profit	60	52	15	4

Sales up 1%
Profit up 4%

Strong operational progress

- Sales up 1%; profit up 4%; margins up 0.9%; strong cash generation.
- Successful format innovation to help address weakness of mass market category in the US, down a further 4% for the industry in 2005. First seven *Penguin Premium* paperbacks published, priced at \$9.99, and all become bestsellers, with authors including Nora Roberts, Clive Cussler and Catherine Coulter.
- Pearson Education moves successfully into new shared UK warehouse in second half of 2005.

Outstanding publishing performance

- Penguin authors win a Pulitzer Prize (for Steve Coll's *Ghost Wars*), a National Book Award (William T. Vollman's *Europe Central*), the Whitbread Book of the Year (Hilary Spurling's *Matisse the Master*), the Whitbread Novel of the Year (Ali Smith's *The Accidental*) and the FT & Goldman Sachs Business Book of the Year Award (Thomas Friedman's *The World is Flat*).
- 129 *New York Times* bestsellers and 54 top 10 bestsellers in the UK. Major bestselling authors include Patricia Cornwell, John Berendt, Sue Grafton, Jared Diamond, Jamie Oliver, Gillian McKeith, Jeremy Clarkson and Gloria Hunniford.

Successful focus on new talent

- Strong contribution from new imprints and first-time authors. New imprint strategy continues to gather pace and Penguin publishes more than 150 new authors in the US and approximately 250 worldwide – its largest ever investment in new talent.
- Sue Monk Kidd's first novel, *The Secret Life of Bees*, has been a *New York Times* bestseller for almost two years; her second, *The Mermaid Chair*, reaches number one in 2005. *The Kite Runner*, Khaled Hosseini's first book, stays on the *New York Times* bestseller list for all of 2005, selling an additional two million copies (three million in total). In the UK, strong performance from new fiction authors including Jilliane Hoffman, PJ Tracy, Karen Joy Fowler and Marina Lewycka.

Continued investment in new markets and international talent

- Launch of regional language publishing programme in India with first ten titles in Hindi and Marathi; approximately 70 new titles to be published in 2006. Acquisition of worldwide English language rights to *Wolf Totem*, one of China's top five bestselling books for more than a year.

Strong 2006 publishing schedule

- Strong list of new titles for 2006 from bestselling authors including Nathaniel Philbrick, Patricia Cornwell, Senator Edward M. Kennedy, Jamie Oliver, Sue Townsend and Jeremy Paxman.