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Restructuring Behind it, Pearson Looks to 2015

With major restructuring completed in 2014, Pearson (London/New York) is looking ahead to greater market stability and larger market opportunity in 2015 with a return to growth in 2015 and even stronger financial returns beginning in 2016.

"We have made Pearson into a single operating company," Pearson chief executive John Fallon said in February when releasing 2014 financial results. "We've accelerated the shift from print to digital and to services, from slower- to faster-growing markets, and to a more focused product strategy based on learning outcomes."

In North America, in particular, Pearson expects more stable college enrollment to contribute to anticipated growth in

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HMH Sees Opportunity in 2015

The top 7 reasons Houghton Mifflin Harcourt (Boston) president and CEO Linda Zecher is upbeat on 2015 (and it is not because net sales are projected to squeak up 2% to 5%):

- 2014 marked a tipping point in the learning transformation with customer demand for digital content;
- HMH will continue to drive the momentum it generated in the digital space in 2014;
- HMH's status as a trusted provider in school districts across the country provides a meaningful inroad to sell additional services to help boost revenue;

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EM DATABANK

MBS and Vital Source Extend Working Relationship

MBS Textbook Exchange (Columbia, MO), a provider of virtual bookstore services with print and digital inventory and used textbook wholesaler, in February picked Vital Source Technologies, a business of Ingram Content Group (Nashville, TN), to be the digital fulfillment vendor for all of its educational content.

The collaboration is aimed at making the selection and distribution process of digital materials more convenient for students and more streamlined for institutions. The agreement spans both higher education and K-12 markets.

The relationship is an enhanced extension of the one MBS had for several years with CourseSmart, Kent Freeman, chief operating officer at Vital Source Technologies,

EM Pulse

U.S. K-12 Education Expenses, FY2012

- Total expenses for public K-12 education decreased 3.3% to $601.8 billion in fiscal year 2012 from fiscal 2011;
- Expenses per student were the highest in DC ($19,847), NY ($19,396), NJ ($17,982), AK ($17,475), CT ($16,855), VT ($16,651), and WY ($15,998);
- Revenues per student decreased by 0.8% on a national basis and 1% or more in 20 states.

Source: National Student Clearinghouse, February 2015 told *EM*. Vital Source acquired CourseSmart, a textbook sampling and ecommerce site, one year ago.

The collaboration with MBS is "a great extension of the kind of thing we are trying to do" with the CourseSmart acquisition, Freeman said. Until the acquisition of CourseSmart in March 2014, Vital Source had not been much of an option for MBS.

CourseSmart provides faculty sampling reach and breadth of inventory; Vital Source provides a delivery platform and fulfillment strategy, Freeman said. Vital Source claims more than 500,000 available titles in distribution, encompassing content from more than 750 educational publishers.

MBS is able to expose the Vital Source catalog and facilitate faculty sampling, extending Vital Source's reach to make it easier for institutions to go digital, Freeman said.

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Changing Market

The collaboration comes as Vital Source is preparing a rebranding later this spring. And, it comes amid a market that is dynamic with possibilities as publishers and distribution providers and bookstores all scramble to deal with the myriad changes swirling around.

For instance, the California State University System, the nation's largest, continues its drive to find more viable and cheaper alternatives to high-price textbooks. In February, 13 of the system's campus libraries began hosting a showcase of free and low-cost digital and print OpenStax (Rice University) textbooks for the spring 2015 term. Faculty can evaluate the resources; students also can see what would be available.

New businesses—like Verba (San Francisco) with its price comparison tool, and Valore (Boston) with new inventory solutions approaches—contribute to the changing dynamics in the market.

MBS is a lot about discoverability, Freeman said, and CourseSmart has been *the* discoverability tool for faculty. "You need a discoverability tool to say what's available."

With the catalog of instructional materials in whatever format, the partnership is more about working with institutions in the changing market, Freeman said.

As institutions move in a more digital direction, with interactive resources in the vanguard, the pay model will move more from a student purchase to an institutional purchase, developing by program and then department, Freeman said.

In what is apt to be a slowly changing market, the MBS model supports both institution and student pay models, Freeman said. "We're trying to make it easier for the institutions," he said. ■

B&N College to Stand on Its Own

Finding the right path forward for a bookstore business in a digital era is a tricky business, and Barnes & Noble (New York) has gone through some very public strategizing and handwriting in the past two years as it tries to navigate that path.

In the most recent recalculation, B&N in February decided that it would spin off its College business and keep its digital NOOK device business as part of its core retail operation. The separation papers were filed Feb. 26 with the SEC. There has been no comment from executives, though they are expected to be more communicative March 10, when the company releases financial results for its fiscal third quarter.

B&N CEO Michael Huseby said in the announcement that the separation would create a “pure-play public company with more flexibility to pursue strategic opportunities in the growing educational services markets.”

This most recent plan recognizes that the NOOK device business probably is a more natural fit with the retail book business. College students have maintained a hearty resistance to reading on-screen for course purposes.

It also is a reversal of the more recent plan that would have left the college business with the core B&N retail business and spun off NOOK on its own. Before that, the working plan had been to spin off the two businesses together as NOOK Media.

The College business generated $977.4 million in revenue in the six months ended Nov. 1, 2014, up 1.4% from the same period the year before.

B&N College operates 714 campus stores in 42 states and DC, reaching 23% of enrolled college students. It is the second-largest college-store operator behind the leader Follett (River Grove, IL) with 940 stores. B&N College also is developing its digital distribution platform Yuzu. ■

Pearson, cont’d. from p. 1

online higher education services, while learning services (curriculum) should be broadly level with fewer new editions. The emphasis is on online services, course design and learning management systems, moving the company from focusing on budgets that account for 5% of total college costs to areas that represent 60% of total costs.

In the K-12 market, Pearson expects growth in its virtual schools and greater stability for curriculum materials and assessments, even with the possibility of more disruption in the policy arena. While the adoption market will be a smaller opportunity than in 2014, Fallon said deferred revenue coming in from 2014 and an expected “improved competitive performance” should help compensate.

Across the company, Pearson is developing new products that are “all about combining new technology with great teaching to expand access, to maximize impact and to improve learning outcomes,” Fallon said.

As part of the company streamlining, Pearson in February tapped Evercore to advise as it tries to sell PowerSchool and its other student information system businesses. PowerSchool, in 2014, contributed $90 million in revenue and $20 million in operating income, serving 13 million students in 70 countries, roughly the same as it had in 2013.

The restructuring process, begun in 2013, was designed to accelerate the shift in the company’s focus to new business opportunities and digital structure. With a return to more normal restructuring in 2015, Pearson does not expect to have a repeat of the £44 million net restructuring charge of 2014 but does expect to generate £45 million in incremental cost savings.

Overall, Pearson revenue of £4.87 billion ($8.04 billion) declined 3.9% but increased 2% at constant currencies.

North America Slides

North America revenue of £3 billion ($4.91 billion) declined 3.2% in 2014 and increased 2% on both constant currency and underlying bases. While revenue in school learning services (instructional materials) and state assessments declined, Connections Academy, VUE and clinical testing, and higher education overall contributed revenue growth.

While Pearson took a loss on the sale of its 5% stake in Barnes & Noble’s NOOK Media, the company came out £2 million ahead with the sale of its stakes in Safari Books Online and CourseSmart.

Weaker U.S. School

Accounting for about 45% of the North America segment, School generated an estimates $2.21 billion in revenue in 2014. Pearson said it lost market share in K-12 with a weaker than usual performance in adoptions, particularly

6-8 science and math in Texas and 6-12 literature and 6-8 math in Florida. Pearson was strong in K-6 math in Texas and California and in 6-12 social studies in Tennessee. Pearson claimed an estimated 25% capture rate of total new adoptions in 2014, which it pegged at $910 million. And, the company said enVisionMATH currently has the largest installed base among elementary students in the U.S.

In testing, Pearson said high-stakes national and state online test volume increased 40% to $11 million, while paper-based test volumes declined 17% to $32 million, driven by fewer tests administered in Texas and California and a continued migration to online testing. Pearson has contracts to administer PARCC contracts in 11 states, and extensions to contracts in Virginia and Maryland. Its contract to administer Florida exams expires in summer 2016.

Higher Ed Growth

Despite declining enrollment of 1.3% (with career enrollment at community colleges and for-profit colleges down 3%), Pearson saw modest gains in learning services, due to market share gains on a strong new edition cycle and growth in digital courseware registrations. Also at 45% of segment revenue, Higher Education accounted for an estimated $2.21 billion in revenue in 2014.

Williams Moves to Pearson CFO

Pearson (London/New York) named Coram Williams chief financial officer, succeeding Robin Freestone, who is retiring.

Williams will join Pearson as CFO designate on July 1 and succeed Freestone as CFO on Aug. 1. He also will replace Freestone on the Pearson board as an executive director.

Williams currently is CFO of Penguin Random House. He joined Pearson in 2002, served in a number of financial roles and was CFO of Penguin Group for five years before it joined with Random House in a new business in 2013.

MyLab registration in North America increased 3% to almost 11 million. The REVEL digital platform was launched for 17 humanities and social sciences courses. New editions included *The Structures and Properties of Chemistry*, Tro; *Economics,* Acemoglu, Laibson and List; and the Pearson Writer application for mobile devices.

Pearson Online Services, which operates fully online programs, grew course enrollments 22% in 2015 through ongoing programs at Arizona State University Online and the University of Florida Online. Pearson signed new programs at Bradley University in Illinois to create five graduate degree programs in nursing and counseling and with the University of Texas, Austin, Dana Center to deliver web courses for the New Mathways Project,

Pearson Financial Results, 2014 vs. 2013[1]

(Period ended December 31; $ in millions)

	Revenue[2]			Adjusted Operating Profit[2]		
	2014	2013	% Chg.	2014	2013	% Chg.
Pearson	$8,042.1	$7,958.3	1.1%	$1,191.3	$1,155.0	3.1%
Operating Margin				14.8%	14.5%	0.3
School	$3,344.6	$3,615.7	-7.5%	$389.4	$420.8	-7.5%
Operating Margin				11.6%	11.6%	0.0
Higher Education	$2,796.8	$2,612.5	7.1%	$509.9	$463.2	10.1%
Operating Margin				18.2%	17.7%	0.5%
Professional	$1,900.8	$1,730.1	9.9%	$174.9	$108.3	61.5%
Operating Margin				9.2%	6.3%	2.9
North America Education	$4,907.1	$4,824.6	1.7%	$765.6	$744.2	2.9%
Operating Margin				15.6%	15.4%	0.2

[1]$ figures calculated by converting British pounds sterling at $1.65 exchange rate in 2014, $1.57 in 2013.
[2]Year-over-year headline percent changes in revenue and adjusted operating profit in $ are not the same as in £. Revenue total excludes Mergermarket and Penguin; Adjusted operating profit does not exclude them. On a pound basis, Pearson's revenue was £4.9 billion, with CER growth of 2%; NA Education revenue was £3 billion, CER was 2%; School at £2 billion, CER change -7%; Higher Education at £1.7 billion, CER growth 8%; Professional at £1.2 billion, CER growth 10%.

Source: Pearson financial report, *EM* conversion of pounds to dollars which will become part of a statewide reform initiative between the Dana Center and the Texas Association of Community Colleges. ■

Chegg Shifts to All Digital as Revenue Grows 19% in 2014

The textbook rental services provider Chegg (Santa Clara, CA), on May 1 will completely hand off the management of the physical books it rents out to students to Ingram Content Group (Nashville).

"With this agreement, we expect that 100% of Chegg's revenue will be digital by 2017," Chegg president and CEO Dan Rosensweig said in February when presenting 2014 financial results.

Last year, Chegg formed a test partnership with industry distribution stronghold Ingram. The agreement essentially shifted the cost burden of buying up book inventory and storing and shipping it to Ingram. Now, Chegg is moving forward with a five-year partnership with Ingram which will be responsible for purchasing all future inventory and managing all backend logistics.

However, Chegg will continue to own the branding and customer experience around textbook rental. The driving force behind this move is to relieve the pressure on Chegg's working capital, which has been consumed by textbook inventory purchases.

"We will no longer use Chegg's working capital to buy textbooks, and since the price of textbooks remains a huge pain point for students, we are pleased to continue offering them the most competitive textbook rental service in the industry," Rosensweig said.

Chegg Q4 and Year-End Financials 2014 vs. 2013
($ in thousands)

	Q4 2014	Q4 2013	Chg.
Revenue	$84,417	$77,116	9.5%
Rental	$53,534	$58,913	-9.1%
Service	$28,206	$16,585	70.1%
Sales	$2,677	$1,618	65.4%
Co. Op. Income/Loss	$2,743	-$8,490	132.3%
Op. Margin	3.2%	-11.0%	14.2%
	2014	**2013**	**Chg.**
Revenue	$304,834	$255,575	16.2%
Rental	$181,570	$189,004	-3.9%
Service	$87,460	$51,958	68.3%
Sales	$35,804	$14,613	145%
Co. Op. Income/Loss	-$65,134	-$51,031	NA
Op. Margin	-21.4%	-20.0%	NA

Source: Chegg financial report

Revenue Grows

Chegg's fourth-quarter revenue increased 9.5% to $84.4 million, driven by continued growth in its Service segment, which grew 70.1%. In the quarter, digital revenue, up 71% to $28.5 million, accounted for 33.8% of total revenue, up more than 10 percentage points from the fourth quarter 2013. At the same time, print revenue decreased to $55.9 million compared to $60.5 million in the same period in 2013.

Full-year revenue increased from 19.2% to $304.8 million from 2013. Digital revenue increased 74% to $91.2 million in 2014 and accounted for 29.9% of total company revenue, nearly 10 percentage points more than the prior year.

Outlook

Overall, Chegg expects first quarter revenue in 2015 to be between $76 million and $80 million, or up 2.1% to 7.5% from first-quarter 2014. Digital revenue is expected to be $29 million to $31 million, or up 62.9% to 74.2%.

The company expects fiscal 2015 revenue of $288 million to $312 million, with digital revenue in the range of $133 million to $143 million. ■

Textbook Exports Down in 2014; Imports Rise

In a reverse of the previous year, the balance of trade in textbooks tipped in favor of imports in 2014, at least in terms of growth rates. The total value of U.S. textbooks exported to foreign markets in 2014 declined 2.2% to $467.8 million, while the value of textbooks imported into the U.S. increased 15.2% to $198.8 million, according to data compiled by the U.S. Department of Commerce.

In comparison, in 2013, exports increased 5% and imports declined 12%. The value of exported textbooks to the biggest foreign markets—the U.K. and Canada—declined, down 16.3% to $136.9 million in the U.K. and down 0.5% to $82.8 million in Canada. The U.K., in particular, has been making changes to curriculum and assessment for schools.

Another top market, Australia, returned to the plus side after completing curriculum changes. The export value to Australia increased 27.7% to $31.4 million. Cengage Learning (Boston) in the latter part of 2014 said it did well with exported programs to Australia after the changes.

South Africa, which was a sweet spot for Pearson (London/New York) in 2013 as it implemented new curriculum materials, did not repeat in 2014. In fact, overall, the emerging markets proved less hospitable to Pearson in 2014, prompting chief executive John Fallon to observe: "In retrospect, of course, we could have chosen a better year to rebrand 'emerging markets' as Growth, because it was the first year, in many (of the markets), that they didn't (grow)."

Fallon added that he expected the Growth operating segment to "live up to that name in 2015." U.S. publishers saw declines in the value of exports to three of the 10 strongest

Top Foreign Markets For Exports And Imports Of U.S. Textbooks 2014 vs. 2013

($ and units in thousands; % Chg. Reflects year-over year change)

			Exports			
	Dollar Value		*Share*		*Units*	
Country	**2014**	**% Chg.**	**2014**	**Chg.**	**2014**	**% Chg.**
U.K.	$136,907	-16.3%	29.3%	-4.9	9,613	-11.3%
Canada	$82,756	-0.5%	17.7%	0.3	6,256	-1.8%
Australia	$31,377	27.7%	6.7%	1.6	2,475	13.4%
United Arab Emirates	$22,751	18.0%	4.9%	0.9	939	8.1%
Mexico	$21,397	75.1%	4.6%	2.0	3,918	69.7%
Korea	$20,153	9.6%	4.3%	0.5	1,092	-23.5%
Singapore	$19,617	-5.3%	4.2%	-0.1	1,552	-19.9%
China	$13,035	3.5%	2.8%	0.2	673	11.5%
Japan	$12,357	30.3%	2.6%	0.6	835	8.8%
Germany	$11,188	24.1%	2.4%	0.5	904	24.7%
Top 10 Total	**$371,538**	**-0.4%**	**79.4%**	**1.5**	**28,256**	**0.8%**
			Imports			
	Dollar Value		*Share*		*Units*	
Country	**2014**	**% Chg.**	**2014**	**Chg.**	**2014**	**% Chg.**
Canada	$61,133	48.8%	30.8%	7.0	8,552	10.6%
U.K.	$46,868	23.6%	23.6%	1.6	2,225	-10.1%
China	$28,600	-28.5%	14.4%	-8.8	7,846	-28.1%
Singapore	$11,441	19.8%	5.8%	0.3	1,551	-31.8%
Hong Kong	$10,481	188.6%	5.3%	3.2	3,293	431.9%
Australia	$8,741	33.6%	4.4%	0.6	113	39.4%
Mexico	$6,082	79.7%	3.1%	1.1	1,033	117.3%
India	$4,748	-5.7%	2.4%	-0.5	335	28.1%
Spain	$2,769	51.4%	1.4%	0.3	234	71.1%
Colombia	$2,067	-13.5%	1.0%	-0.4	463	-34.0%
Top 10 Total	**$182,930**	**20.9%**	**92.0%**	**4.3**	**25,643,324**	**-0.1%**
Total U.S. Exports	$467,839	-2.2%				
Total U.S. Imports	$198,790	15.2%				

Source: U.S. Department of Commerce, U.S. Treasury, U.S. International Trade Commission; *EM* analysis foreign markets; the value of exports to Singapore also declined, down 5.3% to $19.6 million. The market with the highest growth in the value of exports was Mexico, up 75.1% to $21.4 million.

Overall, the biggest decline for exports came outside the top 10 foreign markets. Against an overall decline of 2.2%, the value of exported textbooks to the top 10 foreign markets was almost flat—down 0.4% to $371.5 million. The top 10 foreign markets accounted for 79.4% of the value of all exported textbooks in 2014.

Imports

The sources of imported textbooks are more concentrated with the top 10 accounting for $182.9 million, or 92% of the value of all imported textbooks in 2014.

The largest change in value for a particular source was Hong Kong, where the value of textbooks imported from there increased 188.6% to $10.5 million. The single greatest decline was for China, with the value of textbooks imported from China down 28.5% to $28.6 million. ■

HMH, cont'd. from p. 1

- Continued penetration into adjacent markets—consumer, early childhood, and adult education—and growth in trade and professional development/services businesses.
- HMH starts to recognize deferred revenue from increased billings and digital sales in 2014, helping support top-line performance.
- Growth in open territory states will offset some of the weakness in the adoption market.
- HMH expects to maintain its 40%-plus market share in the K-12 space.

"We feel great about the momentum we've generated in 2014," Zecher said in February when releasing 2014 financial results. "At the same time, we understand that we must remain diligent and focused in order to realize our full potential."

Billings Up; Revenue Down

Companywide revenue of $1.37 billion in 2014 was slightly off (down 0.5%) from 2013. The operating loss of $85.4 million was slightly improved from the $86.6 million loss in 2013.

Company revenue is driven by Education revenue performance, and Education revenue declined 13.8% to $217.9 million in the fourth quarter and slipped down 0.1% to $1.21 billion in the full year.

If the numbers look off for a company that dominated K-12 instructional materials adoptions in 2014, look at deferred revenue, a new feature for publishers as they transition to a digital model.

"2014 was characterized by a strong uptake in billings and digital sales, which led to a significant rise in deferred revenue and cash," said chief financial officer Eric Shuman. "Overall, we finished the year on solid financial footing that we believe will support our future growth."

Billings in 2014 increased 16.1% to $1.6 billion from $1.38 billion in 2014. With the transition to digital comes a shift in product mix, which, in turn has led to increased deferred revenue from subscription products. Deferred revenue of $222 million in 2014—which HMH will recognize over seven years—bumped the company's total deferred revenue balance to $527 million at the end of December 2014, up 77% from 2013.

Education results were driven by a strong adoption market; full-year net sales were relatively flat to 2013 because of the effect of deferred revenue and lower sales in professional development and services, Shuman said.

Education did see 8% growth in the supplemental and intervention business and 13% growth in the assessment

New K-12 Education Services

Houghton Mifflin Harcourt (Boston) in February revamped its professional services offering for K-12, creating the HMH Education Services to provide support services for school districts, administrator and educators. It is expected to reach more than 400,000 educators a year.

The full-spectrum support offering runs from technical planning, curriculum implementation assistance and school improvement planning to individual professional development offerings for teachers. A portfolio menu allows educators to customize their services and includes:

- Leadership and transformational support for schools and districts;
- Data analysis and implementation offerings;
- Technology readiness and planning services;
- Professional development at teacher and classroom level;
- Formative/summative assessment tools ;
- Curriculum-specific in-person and online support.

business, spurred by sales of the new Woodcock-Johnson IV assessment product for assessing learning problems.

Outlook 2015

Looking ahead, Zecher assessed the 2015 new adoption-state opportunity at about $500 million with the overall HMH addressable domestic market at about $2.7 billion, or down 9% from the $3 billion opportunity in 2014. HMH is focused on: Texas for math and science, California math, Tennessee math, and Georgia reading.

Zecher said the market will continue to vary somewhere between $2.7 billion and $3.2 billion over the next several years. Clearly with its focus on adoptions in 2014, Zecher said HMH performed at or above the market in open territories in 2014. In 2015, Zecher said she expects the open-territory opportunity will grow about 6%, as the 8% growth in state tax revenue in 2013 works its way through to school spending. Mainly due to a forecasted smaller adoption market, Zecher said she expected HMH billings to be flat to down 4% and net sales to be up 2% to 5% in 2015.

“We expect to maintain our market share,” Zecher said. “We think we’re only going to be down flat to 4%, primarily due to growth in our adjacent markets—pre-K, early childhood and consumer—and then also to additional development of our services business, which we think is also going to have significant growth.” ■

Around the Schools ...

- **Tulsa (OK) school district** voters on March 3 overwhelmingly approved a $415 million bond package; more than 80% of voters approved each of the four propositions. The bond package will provide: $239.4 million for building facilities and repairs; $138.4 million for textbooks/classroom learning materials; $19.8 million for library; and $17 million for transportation. Among the new projects are a centralized STEM center and provision of individual access to a technology device for each child.

- **Florida** school districts have been updating their instructional materials processes, as per legislation passed in 2014 by the state legislature. Under the new **Collier County** school district policy, passed in February by the district Board of Education, the schools superintendent will appoint review committees consisting of one-third teachers, one-third administrative staff/academic coaches, and one-third parents/community members to review state-approved materials. The 15- to 21-member committee will make recommendations to the school board, which will then vote. Parents can then submit any objections for up to 30 days, when a public hearing would be held to discuss the objections.

Houghton Mifflin Harcourt Q4 and Year-End Financial Results, 2014 v. 2013
($ in thousands)

	Q4 2014	Q4 2013	Chg.	2014	2013	Chg.
Company Revenue	$265,485	$298,877	-11.2%	$1,372,316	$1,378,612	-0.5%
Education	$217,926	$252,763	-13.8%	$1,209,142	$1,207,908	-0.1%
Trade	$47,559	$46,114	3.1%	$163,174	$170,706	4.4%
Co. Op. Income/Loss	-$79,734	-$59,552	NA	-$85,411	-$86,645	NA
Co. Operating Margin	-30.0%	-19.9%	NA	-6.2%	-6.3%	NA
Adjusted EBITDA	$9,052	$54,817	-83.5%	$265,383	$325,018	-18.3%
Education	-$63,638	-$16,310	NA	- $3,206	$5,937	-154.0%
Education Op. Margin	-29.2%	-6.5%	NA	-0.3%	0.5%	-0.8%
Adjusted EBITDA	$13,137	$67,123	-80.4%	$298,483	$343,183	-13.0%
Trade	$535	- $506	20.5%	-$2,919	$6,557	-144.5%
Trade Op. Margin	1.1%	-1.1%	2.2	-1.8%	3.8%	-5.6%
Adjusted EBITDA	$4,831	$4,521	6.9%	$12,675	$24,448	-48.2%

Source: Houghton Mifflin Harcourt financial reports and EM calculations for Education and Trade Q4 operating income/loss and margins