McGraw Hill Financial
1st Quarter 2014 Earnings Conference Call
Prepared Remarks
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Chip Merritt
Vice President, Investor Relations
McGraw Hill Financial

Good morning. Thanks to all on the line for joining us for McGraw Hill Financial's first quarter 2014 earnings call. Presenting on this morning's call are Doug Peterson, 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.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'd like to turn the call over to Doug Peterson.

McGRAW HILL FINANCIAL

Douglas L. Peterson
President and CEO
McGraw Hill Financial

Thanks, Chip and good morning.

It was great to have a chance to meet with many of you during our recent Investor Day. We thank you for your participation and feedback on the event.

Amongst the key messages we delivered on Investor Day is our focus on creating growth and driving performance. Setting annual growth goals, maintaining disciplined capital allocation, more actively managing the businesses, completing our portfolio rationalization, and driving productivity savings are all part of this focus.

The year is off to a solid start despite the decrease in global bond issuance. This morning we reported increases in both revenue and earnings for the quarter. Platts and S&P Dow Jones Indices delivered double-digit revenue growth driving the overall MHFI growth in the quarter.

During Investor Day we spoke about our global footprint and the opportunities we see for international growth. During the first quarter, international revenue growth of 7% was more than twice that of domestic growth. And during the quarter, we reported free cash flow of $85 million and returned $246 million in dividends and share repurchases which continues to demonstrate our commitment to returning capital to shareholders.

If we look at the financial performance during the quarter:

- Revenue increased 5% year-on-year and 6% from organic growth;
- Adjusted operating profit increased 8%;
- We achieved a 100 basis-point improvement in the operating margin; and
- Adjusted diluted EPS increased 12%.

The strength of our portfolio was clearly evident this quarter. Weak issuance hindered the growth at Standard & Poor's Ratings Services but S&P Dow Jones Indices and Commodities & Commercial Markets delivered double-digit operating profit increases.

This chart shows how our non-Ratings businesses comprised 48% of operating profit, up from 41% a year ago. S&P Dow Jones Indices and Platts, once only small parts of our portfolio, have grown into major contributors.

Standard & Poor's Ratings Services

Now, let me turn to the individual business segments and I'll start with Standard & Poor's Ratings Services.

During the quarter:

- Revenue increased 1%;
- Operating profit decreased 4%; and
- The operating margin decreased 220 basis points to 42.2%.

As is widely understood in the marketplace, bond issuance was erratic during the quarter, but overall it was weak. Bank loan ratings, on the other hand, continued to show considerable strength.

The increase in expense was due to investments in human capital in areas of the businesses where we are seeing increasing volumes, as well as in data and technology.

You will note that the methodology for allocating "unallocated expenses" has changed for every business unit. And you'll see that on the upcoming charts and Jack will discuss this in a moment.

You'll see on this next slide that non-transaction growth in the quarter, which in aggregate grew 9%, was driven by annual fees, which increased by 6%. In addition, Rating Evaluation Service revenue increased 33% as the Europe, Middle East & Africa region realized record revenue in this category due to increased merger and acquisition activity. Lastly, strength in CRISIL's Coalition analytical business also contributed.

Transaction revenue from bond ratings in structured finance and corporates decreased as a result of lower bond issuance levels. Global bond issuance, excluding sovereigns, on a par basis decreased 10%; however, the number of issues was down 27%. Because of the tiered pricing associated with larger deals, our total revenue was negatively impacted. Bank loan ratings remained a bright spot, however, with total revenue increasing 19%.

Consistent with 2013 trends, international growth continued to outpace domestic activity. International revenue increased 6% driven by record high-yield issuance in Europe influenced by bond disintermediation. In both the United States and Europe, the first quarter will be the most difficult bond issuance comparison we will face all year. As you will see in the graphics on this chart, during the quarter U.S. corporate and public finance issuance decreased 5% and 26%, respectively. Importantly, U.S. high-yield issuance declined 38%. You will recall that in the first quarter of 2013 high-yield issuance was at a record level. Conversely, in Europe we saw record high-yield issuance, which increased 29%. In fact, this was one of the few times when European high-yield issuance exceeded that of the U.S.

While we are encouraged by the trends in Europe, structured finance issuance remains anemic. Fortunately, the problems of weak issuance and lack of liquidity and capital flows are starting to be noticed by regulators. In a six-page report published earlier this month, the European Central Bank and the Bank of England noted that regulation may be undermining Europe's economic recovery. In particular, they are concerned about the shrinking market for asset-backed securities. The report cited a Standard & Poor's analysis which showed the cumulative default rate on European structured finance assets between July 2007 and the third quarter last year was only 1.5%.

Now, let me update you on developments on the litigation front:

- 36 cases have been dismissed outright;
- 13 dismissals by lower courts that have been affirmed by higher courts; and
- 11 cases that have been voluntarily withdrawn.

That leaves us with a couple dozen non-government cases that remain outstanding.

During the quarter, the Company won a motion to dismiss with prejudice in the Space Coast case, which follows the initial dismissal a year ago. As a result of this decision, Space Coast will not be able to refile another Amended Complaint. Please note that Space Coast is named by the Government as one of the alleged "victims" in the Department of Justice case.

Now, in the DOJ case, on April 15th the Court granted S&P's discovery motion to compel the Government to produce documents relating to the independence or objectivity of ratings or ratings agencies, documents relating to the conduct of mortgage lenders, financial institutions, and issuers of the securities, and documents relating to Standard & Poor's Ratings Services' First Amendment retaliation defense with certain limitations. This ruling will be very helpful to the Company in its defense of the lawsuit.

In the consolidated states cases, we are awaiting a ruling by the Federal District Court in New York on the Attorneys Generals' motion to remand the cases back to the states.

During the first quarter, no new cases were filed.

S&P Capital IQ

With that, let me now move on to S&P Capital IQ which delivered top-line growth of 4% this quarter. Excluding the lost revenue from ongoing portfolio rationalization of several small products, including Financial Communications, Funds Management Research Europe and ABSXchange, organic growth was approximately 6%.

Operating profit increased year-over-year for the third straight quarter and the margin increased modestly. Another highlight of the quarter was that rollouts have begun on desktop capabilities which I will touch on in a moment.

Now, let me review the three business segments within S&P Capital IQ:

- S&P Capital IQ Desktop & Enterprise Solutions revenue increased 4%, principally driven by an 8% increase in S&P Capital IQ Desktop revenue.
- S&P Credit Solutions revenue increased 5%, driven by an 8% increase in RatingsXpress.
- And, S&P Capital IQ Markets Intelligence revenue increased 2%, driven by a 26% increase in Leveraged Commentary & Data, which is known as LCD. LCD is the preeminent provider of leveraged finance news and analysis. The increase was largely offset by shutting down of FMR Europe in the fourth quarter 2013.

During Investor Day, Lou Eccleston discussed five new capabilities we are building for the S&P Capital IQ Desktop in 2014. Credit Analytics was the first of these to launch. With these tools, users can now measure, monitor, and manage the credit risk of companies in mature and developing economies with daily updated credit risk metrics. The new analytic models and workflow tools combine seamlessly with S&P Capital IQ's leading fundamental data and research, addressing needs of credit and financial professionals.

S&P Dow Jones Indices
Now we're going to turn to S&P Dow Jones Indices.

The business delivered another outstanding quarter with an 18% increase in revenue and a 43% increase in operating profit. This growth was primarily driven by increased licensing fees from ETF customers and from exchanges based on increased derivative trading volume. Approximately one-half of the revenue growth, however, was due to a refinement of our revenue recognition for certain products which Jack will explain shortly.

Our licensing agreement for the UBS Commodities Indices expires in June and the contract was not renewed. While we will lose the revenue that was associated with this product, we expect our recent action with the S&P GSCI Index license will largely offset the impact on profits.

Quarter-ending AUMs increased 27% to $667 billion from the end of the first quarter 2013. Importantly, 11% of this increase was the result of new inflows.

Contributing to the strong quarter was an increase in licensing revenue from derivative trading. This was primarily due to SPX and VIX trading volumes, which increased 9% and 24%, respectively. In addition, our relationship with the CME proved beneficial with an 11% increase in the daily volumes of the CME equity complex.

We believe the growth prospects for S&P Dow Jones Indices remain very strong and we continue to make strategic investments such as the following:

- We acquired the remaining intellectual property for the S&P Global Broad Market Index or the BMI. This is a comprehensive, rules-based index — it's designed to measure global stock market performance. The index covers all publicly listed equities with float-adjusted market values of $100 million and currently includes more than 10,500 constituents.
- We also began collaboration with the Korea Exchange for global marketing and sales of KRX Indices. We will leverage S&P Dow Jones Indices' proven experience in sales and marketing to license and further promote the KRX Indices to overseas investors in markets like the U.S., Europe, and Hong Kong. This includes the KOSPI 200, the premier gauge of equity market performance in South Korea. This agreement also paves the way to develop new indices and share knowledge.
- Also, we announced a strategic index development and co-branding agreement with the Taiwan Stock Exchange along with the launch of the S&P/TWSE Taiwan Low Volatility High Dividend Index. As more investors look to Taiwan, S&P Dow Jones Indices' agreement with the Taiwan Stock Exchange will be a momentous step in creating diversified market indices, starting with Taiwanese equities. This agreement is a further sign of our commitment to Asia and to facilitating access to equity market intelligence in the region.

One final note on S&P Dow Jones Indices, on January 24, 2014, we announced along with the CBOE the successful conclusion of the longstanding I.S.E. index litigation. This litigation demonstrates our resolve in defending our legal rights.

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

- Revenue grew 6% in the quarter, but excluding the impact of the sale of Aviation Week, organic revenue actually increased 10%.
- Platts and J.D. Power both delivered double-digit revenue growth, which was partially offset by softness at McGraw Hill Construction.
- Overall operating profit increased 27%, resulting in a 510 basis-point improvement in margin to 30.4%.

As you can see, in Commodities, Platts is off to a great start for the year delivering a 14% increase in revenue for the quarter. Petroleum, Metals & Agriculture, and Petrochemicals all delivered double-digit revenue growth while Power & Gas delivered mid single-digit revenue growth. Due to its size, Petroleum continued to provide the greatest absolute growth while Metals & Agriculture, building on recent investments, provided the greatest growth rate, which was 36%.

I'd like to share an example with you of how McGraw Hill Financial businesses create value across the platform and deliver Essential Intelligence.

Historically, S&P Capital IQ has worked with S&P Ratings to deliver the annual S&P Capital IQ Energy Symposium. This was the first year that Platts and S&P Dow Jones Indices also joined to sponsor and provide speakers for the event. S&P Capital IQ used this event to announce the launch of its new oil and gas estimates, including Average and Total Daily Production of Oil, Gas, Natural Gas Liquids. The team, together, demonstrated the usefulness of this information.

Furthermore, in Commercial Markets, revenue decreased 3%. Excluding the sale of Aviation Week, however, organic growth increased 5% in the quarter. J.D. Power achieved double-digit revenue growth led by the auto business and customer advertising. China continues to significantly contribute to growth in the auto business. Another bright spot is customer advertising which increased 34%, primarily from the Initial Quality Study in autos and several non-auto studies.

As we announced last month, we are exploring strategic alternatives for McGraw Hill Construction but don't have any updates at this time.

Summing up, we are off to a solid start for 2014 and our guidance remains unchanged. After Investor Day, I hope you all have a greater appreciation for the quality of our businesses which was particularly demonstrated by the strength of S&P Dow Jones Indices and Platts offsetting weak bond issuance that impacted Standard & Poor's Ratings Services.

I want to thank all of you for joining the call this morning and now I'm going to hand it over to Jack Callahan, our Chief Financial Officer.

Jack Callahan
Executive Vice President and CFO
McGraw Hill Financial

Thank you, Doug.

Good morning to everyone joining us on the call. This morning, I want to briefly discuss several items related to first quarter performance.

- First, I want to recap key consolidated financial results in the quarter;
- Second, I will review some accounting-related changes;
- Third, I will provide updates on the balance sheet, free cash flow, and return of capital; and
- Finally, I will review our guidance.

In the first quarter:

- Revenue grew 5%, with organic revenue growing approximately a point faster, excluding the impact of the sale of Aviation Week as well as the sale of Financial Communications and small product line closures at S&P Capital IQ.
- Segment operating profit grew 9%, driven by the strong results at Commodities & Commercial Markets and S&P Dow Jones Indices. In addition, after cycling through a period of stepped-up investments, S&P Capital IQ has delivered adjusted profit growth in each of the last three quarters.
- Adjusted unallocated expense increased by $6 million, primarily due to an increase in unoccupied office space resulting from recent divestitures, as well as the timing of certain professional fees. In addition, the first quarter is the most challenging comparison of the year for this particular expense item.
- In line with our previous guidance, the tax rate was 34% in the quarter, a decrease of 100 basis points versus the first quarter a year ago.
- Adjusted net income increased 9%, and adjusted diluted earnings per share increased 12% to $0.89. There was a reduction in average diluted shares outstanding of approximately 7 million shares versus the year ago period.

While there were no adjustments to GAAP results this quarter, there were two accounting-related changes that are noteworthy.

The first has to do with unallocated expenses. As part of the transformation to McGraw Hill Financial, a comprehensive review of accounting and reporting practices and policies was undertaken. As a result, beginning in 2014, all shared operating services will be fully allocated to the segments utilizing a methodology that more closely aligns with each segment's usage of these services. The costs that remain in unallocated expense will be largely corporate center costs, select initiatives, and excess real estate. We included Exhibit 8 in the press release schedules to provide a recast of operating profit, by quarter, for 2013. For 2013 in total, approximately $75 million of these costs have been reallocated to the segments.

The second has to do with refining revenue recognition for certain products. The primary example was for a subset of ETF licensees within S&P Dow Jones Indices. We have incorporated validated data that provides assets under management for a greater portion of ETFs than we have historically had. Therefore, with this new data and history we can now record revenue when earned.

Approximately two-thirds of the ETF-related revenues are already on this methodology. We expect this to be the only quarter meaningfully impacted by this change in revenue recognition.

We continue to maintain an exceptionally strong balance sheet. As of the end of the quarter, we had $1.5 billion of cash and equivalents, of which just under 40% was domestic cash. We continue to have approximately $800 million of long-term debt. Going forward, this strong balance sheet positions us to continue to make investments that strengthen the portfolio and, as appropriate, sustain our share repurchase program.

Our free cash flow during the quarter was $85 million versus negative cash flow of $86 million a year ago. The improvement was primarily due to the timing of tax payments.

It should also be noted that first quarter free cash flow is generally going to be our lowest quarter each year as annual incentive compensation payments are made during this quarter. We continue to expect free cash flow of approximately $1 billion in 2014.

Now let me update you on our return of capital activity. During the first quarter, approximately 2.2 million shares were repurchased at an average price of $78.47 per share. That leaves 47.8 million shares available from December's new authorization. We do anticipate selectively continuing share repurchase activity in 2014, subject to market conditions.

Despite these share repurchases, basic shares outstanding increased modestly from the end of 2013 for two reasons:

- First, 2.3 million employee stock options were exercised during the quarter. Over the last two years employees have exercised significantly more stock options than have been granted. In fact, at the end of 2011 there were approximately 27 million outstanding stock options; at the end of the first quarter there were less than 10 million.
- Second, each year in the first quarter restricted stock plans vest. This quarter, 1.7 million shares of stock were issued associated with the 2011 performance stock plan. With this behind us, and less stock options available for exercise, we expect share repurchases over the remainder of the year to have more impact on reducing shares outstanding.

Now I would like to reiterate our 2014 guidance. There have been no changes.

- We continue to target mid single-digit revenue growth in 2014.
- And as a reminder, the impact of the divestiture of Aviation Week, the sale of Financial Communications, and the shutdown of several smaller product lines at S&P Capital IQ reduces our year-on-year growth rate by approximately one point.
- We are targeting flat unallocated expense and sustained margin expansion with at least a 100 basis-point improvement in adjusted operating profit margin.
- We believe that the effective tax rate achieved in 2013 is sustainable and we are targeting a 34% tax rate in 2014.
- On the bottom line, the adjusted diluted earnings per share guidance is $3.75 to $3.85 per share.
- From a cash perspective, we anticipate investing approximately $125 million in capital expenditures and approaching $1 billion in free cash flow.

In closing, we anticipate delivering continued growth in 2014 as long-term secular drivers of growth, combined with our leading market positions and brands, remain in place. That said, market volatility could impact results as the issuance trends in Q1 demonstrate. Over the balance of the year, we do anticipate a step up in performance especially in the second half.

Again, thank you for joining us today on the call and let me turn it back over to Chip.

To access the accompanying slides online, go to:
http://investor.mhfi.com/phoenix.zhtml?c=96562&p=irol-EventDetails&EventId=5126136

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This presentation contains forward-looking statements, including without limitation statements relating to our businesses and our prospects, new products, sales, expenses, tax rates, cash flows, and operating and capital requirements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are intended to provide management's current expectations or plans for our future operating and financial performance and are based on assumptions management believes are reasonable at the time they are made.

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;
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- 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.