Pearson's strategy: John Fallon, Chief executive

Watch an interview with John Fallon, Chief executive of Pearson.

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As the world's leading learning company, Pearson has a once-in-a-generation opportunity. To seize it, we must transform the company again. Our strategy is settled and sound; we are now accelerating its implementation.

Dear shareholders,

I really do consider it to be a great privilege to be writing to you for the first time as Pearson's chief executive. I had the good fortune to join the company 16 years ago; since then I've worked for Pearson in London, New York and Harlow and travelled to all corners of the world as we've built our education business. I've learned many things in that time, but above all that this is a very special company, with a great sense of purpose and many talented and dedicated people.

In the months since my appointment was announced, I've spent a good deal of time talking to a wide range of stakeholders – customers, shareholders, colleagues and partners – about the company.

Faster into digital, services and emerging markets

My conclusion – based on what I've heard in recent months and learned first hand over the past 16 years – is very straightforward. The Pearson strategy is settled and sound, and we need to accelerate its implementation. We need to move faster in our digital transformation, our move into services and the building of our presence in emerging markets.

OUR STRATEGY

1 Four global businesses

We are focusing on school, higher education, English language learning and business education. We are taking an increasingly global view of educational needs and trends.

2 Four types of geographic market

We will carefully evaluate when we offer global products and services, when we customise for local needs, and when we require a true local approach. We will focus our investment on markets with the biggest growth opportunities.

3 Four business models

We will channel our investment into four proven business models: direct-to-consumer; 'Pearson Inside' (our shorthand for institutional services to schools and universities); assessment; and learning systems.

I want to use this letter to explain why we need to accelerate, and how we will do it.

If you've read Marjorie's letters over the years, you'll be familiar with the key tenets of our strategy and the progress that Pearson has already made. Under her leadership, Pearson set out to become a world-leading education company, and that is a privilege and responsibility we now enjoy. We wanted to make a radical shift from traditional print products to digital and services businesses, and, for the first time in Pearson's history, those now account for half of our revenues. We aimed to become a significant player in the world's most dynamic education markets, and Pearson is now a meaningful education company in China, India, Brazil and Southern Africa. And we've achieved this transformation while sustaining a disciplined approach to capital allocation.

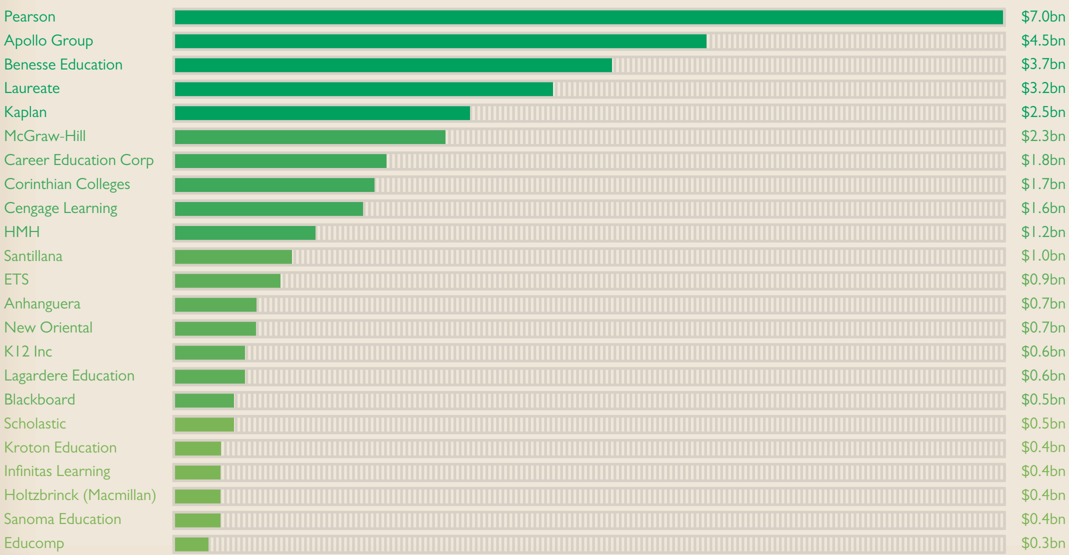
Structural change in the world of education

This is a powerful set of advantages with which to tackle a changing external environment. We continue to see significant structural change, including a shift from print to digital content and from classroom instruction to online learning. Spending on textbooks is flat or declining, while mobile devices, personalised learning and MOOCs (massive open online courses) are on the rise. This shift to digital is profoundly changing the business model for content: it means one-off sales will diminish while subscription sales, most bundled with services, will grow. That same shift to digital causes considerable change and consolidation in the retail channel, with a dramatic shift to online sales and different sales patterns for physical and digital formats.

I'm not going to dwell on the 2012 results here, because Robin Freestone covers them in detail in the next section. But in 2012 we saw plenty of evidence to suggest that those structural changes are gathering speed and force. In many of our traditional publishing markets, we posted another excellent competitive performance. Yet the reward for those efforts was that in some markets we declined at a slower rate than our rivals. At the same time, we draw confidence from strong growth in some of our 'emerging' markets. (We see our fast-growing markets as *categories* as much as *geographies* – they are digital products and services, learning systems, the direct delivery of effective education and learning; as well as fast-growing economies.)

UNIQUE MARKET POSITION

2011 Education revenues

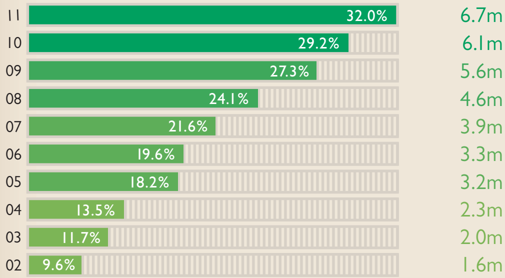


Pearson's strategy: John Fallon, Chief executive continued

Trends

PRINT TO DIGITAL

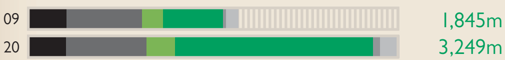
Number of US college students taking at least one online course % total enrolments/millions



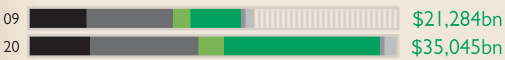
Source: Babson annual online learning survey

THE RISE OF THE MIDDLE CLASS

Numbers of middle class people millions



Middle class consumption, $bn (2005$)

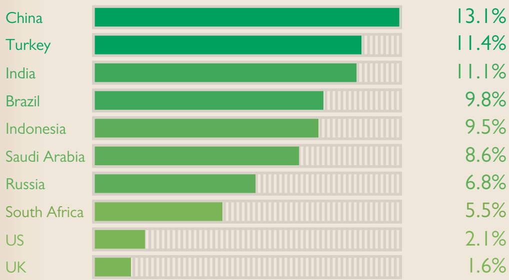


■ North America ■ Europe ■ Central & South America
■ Asia Pacific ■ Sub-Saharan Africa ■ Middle East & North Africa

Source: The Brookings Institution

THE CONSUMER EDUCATION MARKET

Household income spent on education %



Source: Bureau of Labor Statistics, Office of National Statistics, Credit Suisse

Our motto, as you might know, is 'always learning' and there are some lessons for us to learn from all this. We have to manage disruption in our traditional businesses while building direct relationships with learners and leading the digital transformation of education. Our future customers will be consumers, or learners, just as much as the institutions that serve them. We have to tilt the company more quickly toward the biggest sources of future demand. We have to work ever harder to help our customers do more, and better, with less. And we have to focus less on what we *make*, and much more on the measurable impact our products and services can actually *deliver*.

Global education is a once-in-a-generation opportunity

If that all sounds a little daunting, there is another side to the Pearson story. We think education will turn out to be the great growth industry of the 21st Century.

People the world over increasingly understand the fundamental truth perhaps best expressed by Benjamin Franklin: 'An investment in knowledge always pays the best interest.'

The economic returns to education are very clear. For example, 90% of the fastest-growing jobs in the US economy require a college degree and a college graduate will earn, on average over their career lifetime, one million dollars more than a high-school drop-out.

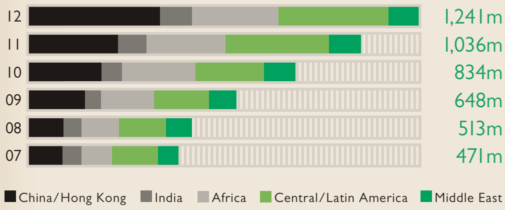
Our growth prospects are also fuelled by a remarkable socio-economic trend: in this decade, the global middle class will almost double in size to more than three billion people. Nearly all of that growth will be in the developing world. That's important to many industries but especially to ours, because as consumers join the middle class and earn higher incomes, they tend to invest more in education – either to advance their careers or give their children a good start in life.

We draw two conclusions from those kinds of trends. The first is that global education is a once-in-a-generation opportunity and Pearson is uniquely placed to grasp it. The second is that, to seize that opportunity, we need to transform the company again.

Our business

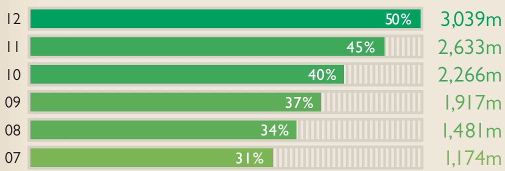
STRENGTH IN HIGH-GROWTH MARKETS

Pearson emerging markets revenues $m



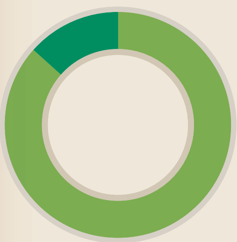
SHIFT TO DIGITAL AND SERVICES

Pearson's digital and services revenues % sales/£m



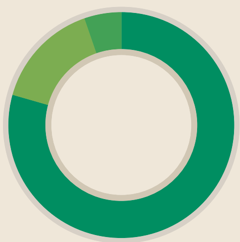
THE NEED FOR TRANSFORMATION – WHERE ARE OUR CUSTOMERS?

Pearson revenues 2012
£bn



Emerging	£0.8bn
Developed	£5.3bn

K-20 % of students
(% CAGR 1998-2010)



North America & Europe	0.2%
RoW	0.6%
Emerging markets	3.1%

Source: Pearson, UNESCO

Transforming the company again

Digital learning services now account for around one-third of our sales. They are growing at more than 20%, but we need to make them a much bigger part of Pearson. Emerging markets are another 15% of our sales. But they already account for more than one-third of the world economy and are forecast to produce more than two-thirds of global growth over the next decade. So, we must radically shift our focus, attention and resources to those very big opportunities. And that is the reason for the changes in the company that we announced with our 2012 results. We need to shift resources more quickly from textbook publishing activities, primarily in the developed world, where demand is flat or declining, so we can invest more quickly in our fast-growing digital and services businesses, with a special emphasis on emerging markets.

Our transformation includes a focus on four global businesses: School, Higher Education, English and Business Education. We are taking an increasingly global view of educational needs, consumer trends and product development for these businesses.

We are applying a new model where we group markets, or countries, in four categories and allocate capital accordingly: 'growth' markets where we see the biggest opportunities; 'watch' markets where we see potential for big growth; 'maintain' markets where we have good businesses but see more modest future growth; and 'drive' markets where we will work through local partners to meet those countries' needs more effectively.

Our framework also involves shifting an increasing proportion of investment into our faster-growing and proven service-oriented models. They are: direct to consumer, building on the success of initiatives such as our language schools in China; 'Pearson Inside,' shorthand for comprehensive institutional services such as our virtual schools in the US and school systems in Brazil; assessment and certification of students and professionals; and personalised learning systems, which deliver individual learning through systems of instruction combined with measurement frameworks and diagnostic assessment.

Pearson's strategy: John Fallon, Chief executive continued

An important part of that transformation is the merger of our consumer publishing business, Penguin, with Bertelsmann's Random House, which we expect to complete this year. Penguin has been part of Pearson for more than four decades. It is a special company that is deeply intertwined with Pearson's culture and operations. But it had become increasingly clear that, in a rapidly-changing consumer books industry, Penguin's creative and financial success could best be secured in combination with Random House, which we viewed as the ideal partner. This will be an excellent business and we will be active long-term partners in it.

Another important component will be business education, which we see as part of our once-in-a-generation opportunity. There is a substantial market for learning for globally minded, highly aspirational business people, and if there is one brand in the world that could turbo-charge our ability to capture that market, it is the *Financial Times*. We are actively exploring this opportunity.

A focus on outcomes

There is one other major component to the changes we are making. For decades, Pearson has provided *inputs* into the process of education: a textbook, an assessment, a course, a qualification. We would put all of those things in the hands of an experienced teacher or an enthusiastic student. In most cases, we would not be able to predict or measure learning *outcomes*.

Under the leadership of our chief education advisor, Sir Michael Barber, we have spent the past two years developing a framework and a set of tools that will change that. The Pearson efficacy framework is a unique, rigorous and scalable quality assurance system that checks that the necessary conditions are in place for an education programme to deliver the intended learning outcomes. We have reviewed almost 100 Pearson programmes under this framework, and we are improving our products and services by acting on the findings. We also are now making an efficacy review a requirement for any new product investment of $3m or more, and for any acquisition proposal. Over time, this will also improve our rate of innovation and invention.

Building on our record of strong performance

Those measures on efficacy complement our more traditional financial measures and goals but they do not, of course, replace them. We will build on Pearson's record of consistently strong financial performance, because profits and cash will fuel the transformational investments that we need to make. Meeting those financial measures will require us to make hard choices about where we choose to invest and what we have to do less of or stop doing altogether.

For, if 2012 was tough, then there are many reasons – cyclical, structural, competitive, consumer led – why 2013 is likely to be tougher still. Many of our markets – especially in the developed economies and where we are particularly dependent on our more traditional product models – have been in decline for some years now.

All this change is going to be challenging for Pearson. It is not a revolution: Marjorie's own leadership of the company was characterised by constant, restless change. However, we do need to accelerate that change – into emerging markets, into services and in our digital transformation – very quickly now.

As we do that, we very much appreciate and rely on the support of our shareholders. By investing in Pearson, you've made an investment in knowledge and education. We will be working as hard as we possibly can to be sure that Benjamin Franklin's words apply to your investment, too. And we'll be inspired, too, by Marjorie's great achievement – demonstrating time and time again that the best and most sustainable way for a company to prosper is to meet an important need in society and to do it really well. We'll be striving very hard to live up to her example.

John Fallon Chief executive