Financial highlights

In financial terms, Pearson's goal is to achieve sustainable growth on three key financial goals – earnings, cash and return on invested capital, and reliable cash returns to our investors through healthy and growing dividends. Over the past five years, we have produced consistent and considerable growth on all measures. In 2012, though we performed well competitively in tough market conditions, headline earnings and cash were lower than the previous year. Our return on invested capital was level at 9.1% and we are proposing a 7% dividend increase.

	2012 £m	2011 £m	HEADLINE GROWTH	CER GROWTH	UNDERLYING GROWTH
Business performance*					
Sales	6,112	5,862	4%	5%	(1)%
Adjusted operating profit	936	942	(1)%	1%	(2)%
Adjusted earnings per share	84.2p	86.5p	(3)%		
Operating cash flow	788	983	(20)%		
Free cash flow	657	772	(15)%		
Free cash flow per share	81.7p	96.5p	(15)%		
Return on invested capital	9.1%	9.1%	–		
Net debt	(918)	(499)	(84)%		
Statutory results					
Sales	5,059	4,817	5%		
Operating profit	515	1,118	(54)%		
Profit before tax	434	1,047	(59)%		
Basic earnings per share	40.5p	119.6p	(66)%		
Cash generated from operations	916	1,093	(16)%		
Dividend per share	45.0p	42.0p	7%		

*Total business (Includes Penguin, which is discontinued in our statutory accounts.)

Note
Pearson's 2011 statutory results include a £412m profit on the sale of our 50% stake in FTSE International. The 2012 statutory results include £113m in closure costs related to Pearson in Practice.

Throughout this document:
a) Growth rates are stated on a constant exchange rate (CER) basis unless otherwise stated. Where quoted, underlying growth rates exclude both currency movements and portfolio changes. Sales and operating profit are stated on a continuing basis, unless otherwise stated.
b) The 'business performance' measures are non-GAAP measures and reconciliations to the equivalent statutory heading under IFRS are included in notes 2, 8 and 34 to the annual report.

2012 SALES

£6.1bn

+5%

2012 ADJUSTED OPERATING PROFIT

£936m

+1%

OUR FIVE-YEAR RECORD

Average annual growth in headline terms 2007–2012

Adjusted earnings per share

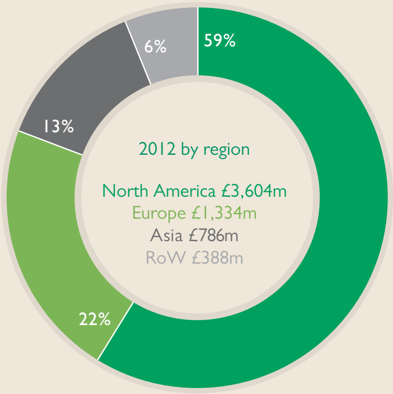
+13%

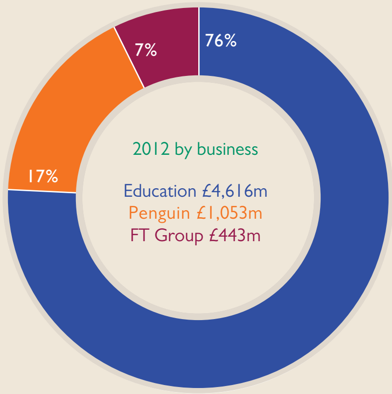
Operating cash flow

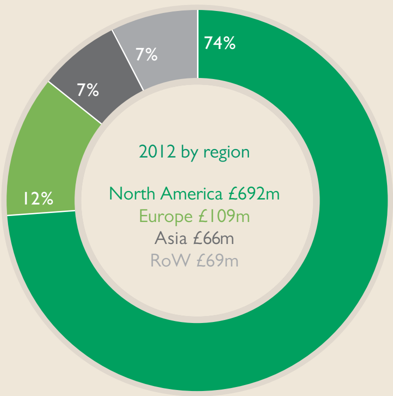
+3%

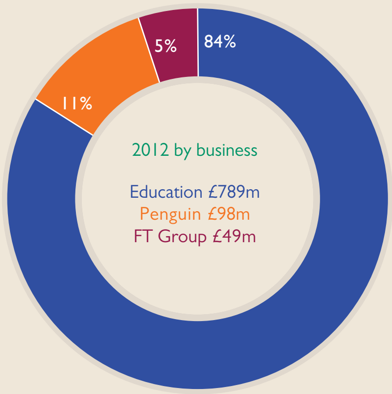
Dividend

+7%

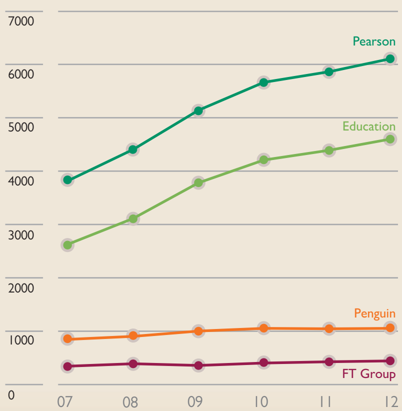




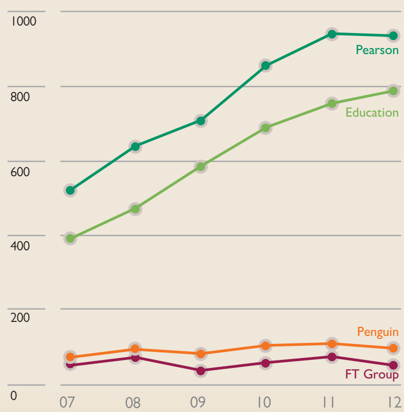




Sales £m



Adjusted operating profit £m



Chairman's introduction

Watch an interview with Glen Moreno, Chairman of Pearson.

ar2012.pearson.com

The basic direction of our strategy is unchanged, and we are travelling faster in our transformation.

Dear shareholders,
2012 was a year of significant leadership transition at Pearson. Marjorie Scardino retired on 31 December, after a remarkable 16-year tenure as chief executive, and John Fallon assumed the role on 1 January of this year.

Marjorie's contribution to Pearson has been defining:

› she led the transformation of a traditional family holding company into a modern global enterprise;

› she established a clear company purpose: to help people improve their lives through learning;

› she developed a company culture – to be brave, imaginative and decent – which will be a lasting legacy;

› and she leaves behind a thriving company which has benefited customers, staff and shareholders.

We all are hugely grateful for her efforts and accomplishments.

CEO succession

CEO succession is a very important board responsibility, and one that we have been working on for several years. In 2012, the nomination committee spent a great deal of time evaluating candidates and planning for a seamless handover of duties.

We are confident that John Fallon is the right person to lead Pearson in its next phase of development, and his leadership over the past few months has reinforced that confidence.

We are now focused on the future development of our board, which I address in the Governance section of this report.

Pearson's transformation so far

Over the past decade or so, Pearson has focused on three fundamental transformations:

› from a media holding company to an integrated education company;

› from a largely Anglo-American company to a truly global enterprise;

› from an analogue print publisher to a digital content and services company.

SHARE PRICE PERFORMANCE

One year % change

Pearson	-1.8%
FTSE 100	5.8%
FTSE All-Share Media	19.0%
STOXX 600 Media	17.4%

Three year % change

Pearson	33.3%
FTSE 100	9.0%
FTSE All-Share Media	39.6%
STOXX 600 Media	19.0%

Five year % change

Pearson	62.3%
FTSE 100	-8.7%
FTSE All-Share Media	18.3%
STOXX 600 Media	-16.1%

Source: Datastream to 31 December 2012

TOTAL SHAREHOLDER RETURN

One year % change

Pearson	1.9%
FTSE 100	10.0%
FTSE All-Share Media	23.1%
STOXX 600 Media	22.5%

Three year % change

Pearson	48.6%
FTSE 100	21.2%
FTSE All-Share Media	53.2%
STOXX 600 Media	34.8%

Five year % change

Pearson	99.3%
FTSE 100	10.6%
FTSE All-Share Media	39.9%
STOXX 600 Media	4.1%

Source: Datastream to 31 December 2012

The driving forces behind these transformations are building. They include the recognised need for more effective and affordable education, especially from the growing middle class across the globe, and the inexorable tide of "disruptive" technologies which are transforming education models.

These forces provide Pearson with huge opportunities, but also challenges.

A challenging 2012

As CFO Robin Freestone outlines in his report on our financial performance, 2012 was a challenging year for many of our businesses, offset by encouraging growth in our newer global and digital initiatives.

These challenges were reflected in our share price performance, which underperformed our indices.

On a longer-term basis, our share price and total shareholder return continue to reflect outperformance. (See charts opposite.)

Transformation and acceleration

As John explains in his CEO report, the basic direction of Pearson's strategy will not change. Indeed, our efforts to transform the company will accelerate.

Significant restructuring (including the Penguin Random House merger), accelerated technology investment and increased operating efficiency will enable us to reach our strategic goals more rapidly.

As a shareholder, I am very confident about Pearson's future.

All great businesses are based on fundamental customer demand, and the global demand for affordable, effective education is huge and growing.

We believe that Pearson, as the world's leading education company, is uniquely positioned to help meet that demand – and we are rapidly transforming the company to do so effectively and profitably.

We are determined to succeed, and our efforts will be of great benefit to both our customers and our shareholders.

Glen Moreno Chairman

Pearson's strategy: John Fallon, Chief executive

Watch an interview with John Fallon, Chief executive of Pearson.
ar2012.pearson.com

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.

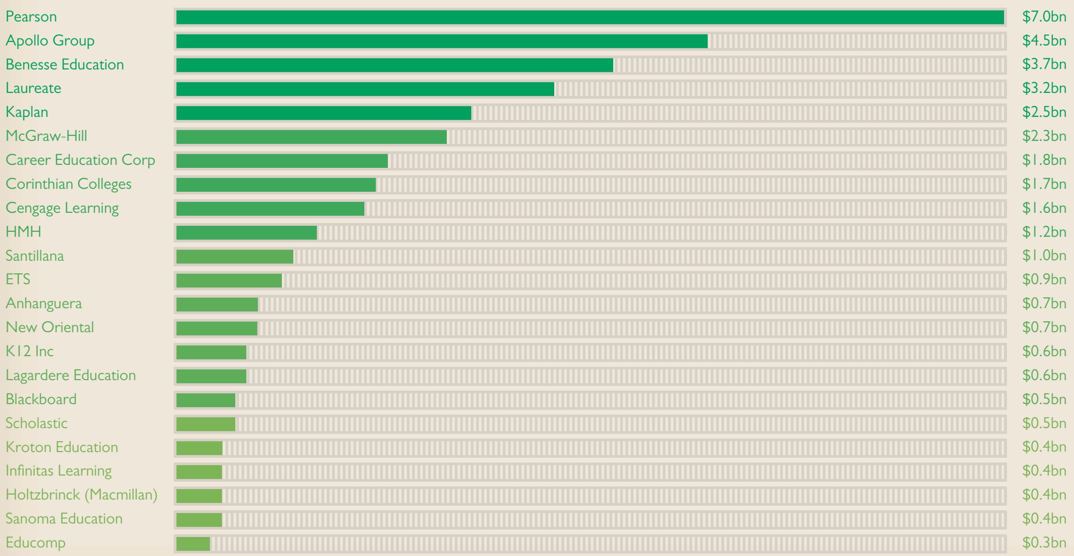
Structural change in the world of education

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

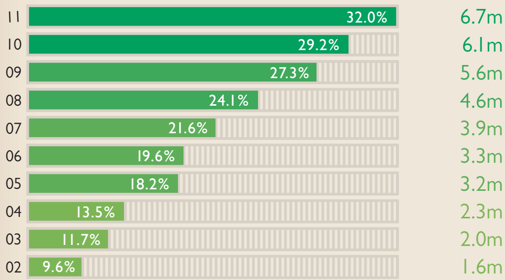


Pearson's strategy: John Fallon, Chief executive continued

Trends

PRINT TO DIGITAL

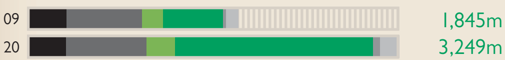
Number of US college students taking at least one online course % total enrolments/millions



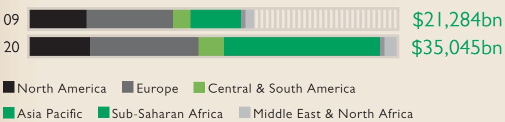
Source: Babson annual online learning survey

THE RISE OF THE MIDDLE CLASS

Numbers of middle class people millions



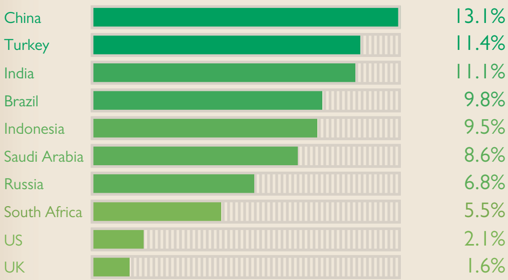
Middle class consumption, $bn (2005$)



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.

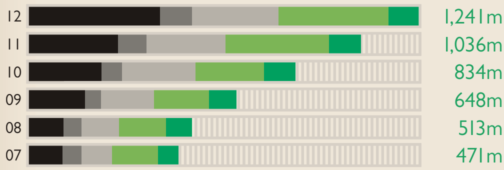
Our growth prospects are also fuelled by a remarkable socio-economic trend: in this decade, the global middle class will almost double in size to more than three billion people. Nearly all of that growth will be in the developing world. That's important to many industries but especially to ours, because 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

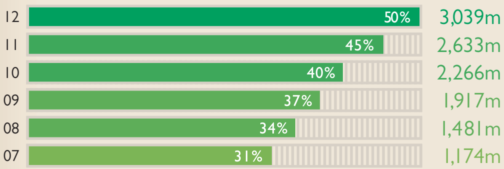
STRENGTH IN HIGH-GROWTH MARKETS

Pearson emerging markets revenues $m



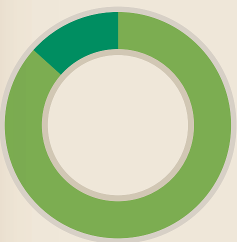
SHIFT TO DIGITAL AND SERVICES

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



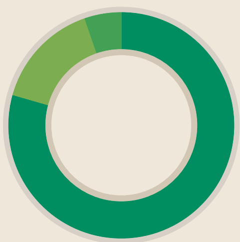
THE NEED FOR TRANSFORMATION – WHERE ARE OUR CUSTOMERS?

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.

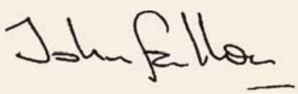
Building on our record of strong performance

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