KILLIK & Co

19 January 2012

Large Cap

.COMPANY:	EPIC:	MARKET CAP:	RECOMMENDATION:	RISK RATING:	PRICE:
Pearson	PSON.L	£9.9bn	Neutral Initiating Coverage	6 CATEGORY: UNRESTRICTED (see bottom of note for risk categories)	1230p

Pearson is an international publishing company with market-leading positions in education, consumer books and business information.

The group has built a strong position in each of its markets, and is well placed to benefit from structural changes towards digital delivery, personalisation, subscription services and mobile devices.

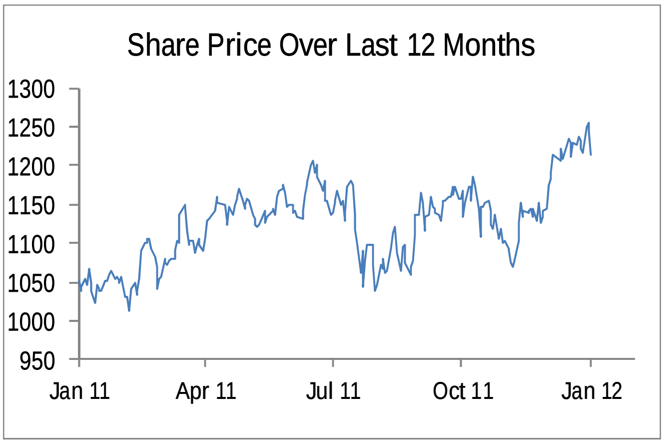
Although earnings momentum has been positive over the last year, the group faces some near-term headwinds as a result of pressure on government budgets and consumer expenditure. As a result, we believe the pace of upgrades may slow.

Following a strong share price performance – up 15% over one year and up 85% over three years – the stock is now trading on 14.5x consensus 2013 earnings.

We would therefore look to take profits, and re-visit the story later in the year.

52 Week High	1266p
52 Week Low	998p
Price to Book Value	1.8x
Dividend Yield	3.4%
Free Cash Flow Yield	8.0%
Dividend Cover	2.0x
Net Debt	£1,275.0m
Interest Cover	7.2x
Emerging markets sales	15%
Next announcement	27 February 2012

Source: Company Data and Bloomberg Consensus



Year End	Sales (£m)	PBT (£m)	EPS (p)	PE (x)	DPS (p)	Yield (%)
Dec 2010	5,663	853	77.50	15.9	38.7	3.1
Dec 2011	5,919	845	82.90	14.8	42.1	3.4
Dec 2012	6,248	890	85.40	14.4	44.4	3.6
Dec 2013	6,480	960	91.50	13.4	47.1	3.8

Jonathan Jackson (Head of Equities)
Arjun Venu (Equity Analyst)
Nicolas Ziegelasch (Global Equity Analyst)
Mick Gilligan (Head of Research)

Unmistakably KILLIK & Co

Pearson is an international publishing company with market-leading positions in education (Addison-Wesley Longman), consumer books (Penguin) and business information (FT Group). The group has embarked on a long-term process of investment and has built a series of competitive advantages including digital leadership, educational effectiveness, positions in fast-growing economies and operating efficiency. As a result, the group is well placed to benefit from a shift to digital services and growth in emerging markets, from which it now generates revenues of £2.0bn and £600m, respectively.

The group recently issued a year-end trading update ahead of the release of its 2011 results on 27 February. The statement highlighted that the group performed well in tough market conditions and continued to take market share. The group now expects to report 2011 adjusted EPS growth of approximately 10% (i.e. 85.3p), ahead of the previous guidance of "approximately 83p". The results have been bolstered by a lower interest charge (£55m), a tax rate at the low end of the 22%-24% guidance range, the benefit of acquisitions (even after expensed integration costs), and the strong dollar. The group generates 60% of its sales in the US, and a five cent move in the average £:$ exchange rate has a full-year impact of 1.3p on adjusted EPS. Although most of today's upgrade is due to non-trading items, the group has clearly performed well across all of its divisions through the important year-end selling season.

The US-biased Education business supplies teaching materials to schools and colleges, and operates a contract-based testing business. We believe the industry is undergoing long-term structural growth, driven by the realisation that a better education leads to a higher salary over an individual's working lifetime and faster economic growth for a country as a whole. Spending on education remains a key priority for every administration and this, combined with the group's strong market position (especially in testing and technology), leaves Pearson well placed at a time when its financially-stretched competitors have struggled to invest. We would also highlight that Apple is planning to launch a new iPad education tool, although it is unclear whether the offer will compete with the publishers or be in the form of a partnership. However, given Pearson's strong existing position in digital products, the company is much better placed than it peers.

In North America, the school and higher education publishing industries have been weak as a result of state budget pressures, the transition to Common Core Standards and slower college enrolments. Against this background, however, Pearson has continued to gain market share and grow rapidly in digital learning. These strengths, together with a resilient performance from its education technology and services businesses, have enabled the group to offset weak market conditions.

Outside of the US, the International Education business focuses on fast-growing markets in China, India, Africa, the Middle East and Latin America, and is well placed to benefit from the increased demand to learn the English language. During 2011, the group continued to perform well in developing markets, digital learning, assessment and English Language Teaching, while macroeconomic pressure in developed markets resulted in school publishing remaining generally subdued. In Professional Education, the group is involved in publishing, training and testing. The business grew in the fourth quarter, with good growth in professional testing and digital publishing.

Penguin, the group's consumer publishing division, achieved a strong performance in its key trading season, and will report solid results despite rapid industry change and tough conditions in the physical book retail market. The business continues to benefit from its innovation and scale in the fast-growing digital books market.

FT Group, which includes the industry-leading Financial Times, expects to report good growth despite weak and volatile advertising market conditions. Digital and subscription-based revenues at both the FT and Mergermarket have continued to climb. At the beginning of January, the FT increased the cover price of the daily title from 220p to 250p, and the weekend title from 280p to 300p. Although there may be some slippage in circulation as a result, the increased revenue from price will fall through to the bottom line.

Pearson has a strong balance sheet providing the firepower to invest in its three priority areas. Firstly, is organic investment, an excellent use of cash given the group's strong position in growth markets. Secondly, bolt-on acquisitions, where strong growth is being achieved from recent deals in the areas of online education systems, emerging market education and vocational training. Recent deals include Connections Education in the US and Global Education in China. At the same time, the group has raised cash from disposals as it looks to reshape the portfolio. Last month, the group announced sale of its 50% stake in FTSE International, a world-leader in the creation and management of market indices. The £450m raised highlights the ability of the group to unlock hidden value from within its portfolio of assets. Finally, the group has a long-term track record of increasing the dividend ahead of inflation, and, following an 8%

hike in the 2011 interim payout, we expect a good growth in the final payout to be announced with the results in February. The shares currently yield 3.4%.

Looking forward to 2012, the group faces a number of non-operating headwinds. The benefit of the one-off interest and tax charges will fall away, while the sale of the FTSE International business will dilute earnings by around 3%. The group also expects to expense further integration costs in its education business following recent acquisitions. However, as the year progresses we expect some of this to reverse as the group reinvests the proceeds in new acquisitions, while the current strength of the dollar is also helpful. The statement contained little detail on the operational outlook for 2012.

In the long term, we believe Pearson is well placed to benefit from the structural changes in its markets towards digital delivery, personalisation, subscription services and mobile devices. In the near term, the group continues to produce a strong competitive performance in generally weak market conditions.

Following a strong share price performance over recent months, the stock is now trading on 14.5x consensus 2013 earnings. Although earnings are expected to benefit as the group continues to put its balance sheet to work through acquisitions, the current valuation is fairly full and we would look to take profits, especially given continued near-term headwinds in some of its markets and the potential uncertainty arising from the education announcement from Apple.

KILLIK & Co

19 January 2012

Large Cap

KILLIK & Co RESEARCH RECOMMENDATIONS					
Equity Research			*Fund Research*		
Large Cap	*Mid Cap*	*Global*	*Absolute Return*	*Income*	*Growth*
Investment ideas in the FTSE 100 which we believe will generate returns ahead of the All-Share index.	*Investment ideas in the FTSE 250 which we believe will generate returns ahead of the All-Share index.*	*Global investment ideas which we believe will generate returns ahead of the FTSE World (ex UK) index over the long term.*	*Funds that aim to generate an absolute return over the medium to long term, i.e. a positive return irrespective of equity or bond market direction.*	*Income producing funds, which are attractive in the context of the yield available from cash, gilts and UK equities.*	*Funds which we believe have the potential to generate a high level of capital growth over the long term.*

KILLIK & Co RESEARCH PERIODIC PUBLICATIONS		
Daily Note	*ETFs Bulletin*	*Thematic*
A summary of the day's newsflow and an update of opinion on covered stocks.	*Focusing on London-listed Exchange Traded Funds (ETFs) and Exchange Traded Commodities (ETCs).*	*A number of direct equity and fund ideas that are well positioned to exploit a key investment theme.*

The Killik & Co Research Policy and recommendation definitions can be found at www.killik.com/research

The Killik & Co Risk Rating system uses categories which are intended as guidelines to the specific risks involved, as follows:
Restricted Lower Risk (1), Restricted Medium Risk (2-3) and Unrestricted (4-9).
Please see the Killik & Co Terms & Conditions for further detail.

Disclaimers