S&P Global
Market Intelligence

Pearson plc LSE:PSON

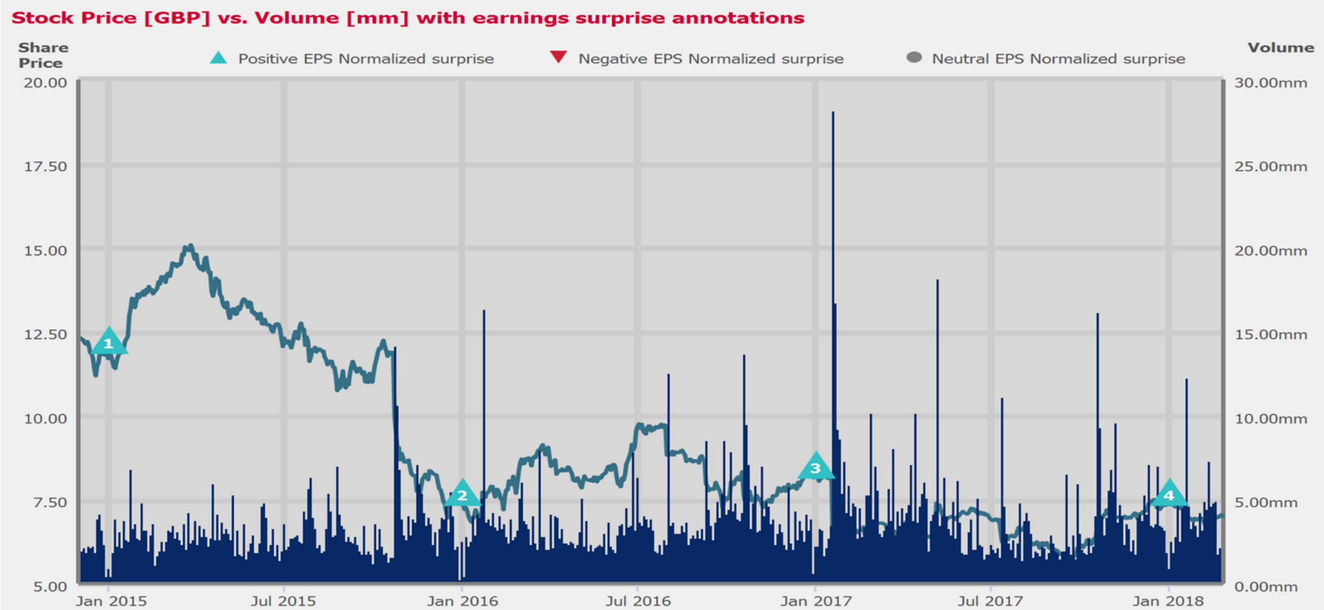
FY 2017 Earnings Call Transcripts

Friday, February 23, 2018 9:00 AM GMT

S&P Global Market Intelligence Estimates

	-FY 2017-			-FY 2018-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS
EPS Normalized	0.52	0.54	▲3.85	0.50
Revenue (mm)	4586.23	4513.00	▼(1.60 %)	4158.06

Currency: GBP
Consensus as of Feb-23-2018 8:30 AM GMT



	- EPS NORMALIZED -		
	CONSENSUS	ACTUAL	SURPRISE
FY 2016	0.57	0.59	▲1 3.51 %
FY 2017	0.52	0.54	▲2 3.85 %

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Call Participants

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Presentation

John Joseph Fallon
CEO & Executive Director

Okay. Good morning, everybody. Thanks for joining us. I'm John Fallon. I'm here with our Chief Financial Officer, Coram Williams. We also have the executive team with us who I'll introduce when we get to the Q&A; and our Chairman, Sidney Taurel is also with us this morning.

Just before Coram takes you through the details of our 2017 financial results on our outlook for the year ahead 2018, let me just pick out a few headlines. In terms of the financial headlines, revenues, adjusted operating profit and earnings per share, all, as we indicated, they would be in our January trading update. Three new points to note today are: operating cash flow of GBP 669 million with a very healthy conversion rate of 116%. As a result, year-end net debt at GBP 432 million is better than the GBP 500 million number we previously flagged, and down more than 60% on last year. And the board, as you can see, is recommending a full year dividend of 17p, which is comfortably covered by our earnings, excluding the contribution from our minority stake in Penguin Random House.

And that leads me to the key headline for today is that, we've delivered on the goals we set out a year ago. Operating profits are at the top end of the guidance range. We're performing well in markets that have played out much as we expected, and that strong balance sheet is enabling us to invest in our digital transformation and return excess capital to shareholders. We further simplify the portfolio with the GEDU, WSE and Utel sales, all announced or completed. And you'll see that today, we've concluded our U.S. K-12 courseware strategic review and are holding the business for sale.

With that deal done, we'll then be happy with the Pearson portfolio. We think we've got the right mix of businesses, although, of course, we will keep it under regular review. The industry-wide challenges in our U.S. Higher Education courseware business will continue this year, but we're now on top of them. And we're making good progress in moving that business to a more sustainable and attractive model. And in the remaining 70% of Pearson, we expect to grow revenues this year. And that will help to all 100% of Pearson, the whole of the company, to deliver underlying profit growth in 2018. So we're making good progress on implementing the strategy, and we're confident that 2018 is going to prove to be both a successful and pivotal year.

So let's have Coram take you through the detail of the 2017 results and our guidance for 2018. And then I'll be back to say more about the factors that underpin our growing confidence. Coram, over to you.

Coram Williams
CFO & Executive Director

Thanks, John. Good morning, everybody. So let's start with an overview of our financial performance. Revenue, operating profit and EPS are all at the upper end of the pre-close view that we shared with you in January. But our cash flow performance is considerably better than our conservative early forecast, leaving us with net debt of GBP 432 million at the end of 2017.

Operating cash flow rose by 1% in headline terms, despite a decrease in operating profit. Cash conversion was 116%, driven by tight working capital management, lower returns and good cash Penguin Random House dividends, offsetting continued investment in product and CapEx.

So let me now walk you through the detail in each area. Let's start with sales. In North America, underlying sales declined 4% versus the prior year, mainly due to: One, continued pressure on our higher education courseware business, which was down 3%. The drivers of that were broadly in line with our expectations, except that we think enrollment and OER were slightly smaller drag than our initial model suggested. We did benefit from lower returns seen throughout the year, but this benefit was partially offset by cautious buying behavior from our channel partners in the final quarter; two, we saw further impact from the contract losses in student assessment that we've told you about previously; three, we saw softness in K-12 courseware driven by our lack of participation in the largest adoption opportunity, California ELA, and weakness in open territories later in the year; and four, Learning Studio declined by around GBP 13 million in 2017, and we're planning for the remainder GBP 11 million of annual revenue from this product to decline to close to 0 by the time it retires in 2019.

The performance of our OPM and virtual school businesses partly offset these declines, with both delivering revenue increases of around 3%. This was driven by good enrollment growth across their portfolio partnerships, partially offset by contract exists. Both businesses ended 2017 with strong pipelines, and we expect modestly better growth in 2018.

Professional certification was flat in North America as a result of the phasing of new contract, but we'll benefit in 2018 from the ramp-up of our new contract to administer the U.S. MCAT, Medical School admission test.

In Core, underlying overall sales were flat. Revenues more than doubled in the Pearson Test of English, and we saw good growth in OPM. But this upside was offset by a number of other factors: Firstly, modest declines in U.K. qualifications, as revenues lagged the stabilization we've seen in registrations, following a long period of policy change; and two, declines in courseware in Europe and smaller African markets, together with some minor business exits.

In growth, underlying sales were also flat. We saw increases in a number of key areas: Firstly, South Africa grew 7%, driven by a recovery in spending on school textbooks in some provinces; two, China grew in both English courseware and in Wall Street English, the latter driven mainly by new center openings; and three, we also saw higher sales in the Pearson Test of English, in both India and China. These upsides were offset by: One, declines in Brazil due to economic pressures; and two, lower enrollments in CTI, our university in South Africa, together with some smaller business exits.

Turning now to profits. Our adjusted operating profit is GBP 576 million, slightly ahead of the GBP 570 million to GBP 575 million preliminary range we gave in January and at the top end of the guidance range that we gave at the start of 2017. In North America, underlying profits reduced 10% driven by sales declines and investment in OPM, partly offset by restructuring benefits from the 2016 reorganization. In Core, the decline of 14% was due to revenue mix, investment in new products and services, partially offset by restructuring savings.

In growth, operating profit increased 3%, reflecting the higher revenues in China, South Africa School Courseware and Pearson Test of English, together with the benefits of restructuring, partially offset by lower revenues in Brazil.

This slide shows the profit bridge we gave you in January. We've updated the bridge to reflect our 2017 final numbers, although the changes are minor. As I said then, the impact of disposals, challenging trading, other operational factors in inflation, were partially offset by restructuring savings.

These savings were largely driven by the incremental benefits of our 2016 restructuring program, but we also saw a small early benefit from the 2017 to 2019 plan.

Other operational factors in staff incentive was lower than the combined GBP 115 million that we guided to at the beginning of the year, reflecting slightly higher incentive payments, as a result of a good performance against plan, more than offset by tight cost control.

We've traditionally given you the revenue split of our business by geography and product and here it is for 2017. But for the first time, the next slide gives you the product contribution split for the group, shown in the same way. Let me walk you through it.

We define product contribution as the profit made by each product's area before the allocation of geography and centrally-managed costs. That means this is showing the share of profits after directly attributable product and salary costs. It's the way that we measure and manage profitability within our businesses. The majority of the segments, generates a similar proportion of product contribution to sales, resulting in segmental margins, generally being in line with group margins. But the analysis does show there are 2 notable businesses which have lower than average contribution: Firstly, our OPM business is low margin in the short term because we're investing in ramping up programs ahead of the shared tuition revenue that comes with enrollment growth. Longer-term, profitability will improve significantly; two, North American school courseware has historically been below Pearson's average profitability, due to the structural pressures in that market. Both pressures were worsening the short term, putting profitability under further pressure.

Amongst the businesses that share higher than average contribution, other ones you'd expect, Core student assessment, U.S. Clinical Assessment and U.S. Higher Education courseware. The key point here though, is that there is no overdependence on one particular business in terms of profitability. And over time, the combination of growth and our ongoing simplification efforts will mean the profit is spread more evenly.

I turn now to the income statement. Interest cost was in line with guidance of GBP 79 million. Our tax rate of 11.1% was lower than expected. Essentially we released some provisions for uncertain tax provision -- positions as statutes of limitations expired. EPS was 54.1p, down on 2016 in headline terms, but above our revised guidance given in October.

Our statutory profit of GBP 408 million, represented a substantial improvement on last year's result, which included a significant impairment of goodwill.

Moving on to our 2018 guidance, this slide summarizes the profit and EPS guidance that we gave you in January. This is not changed since then, but we've also summarized expectations for the balance sheet in 2018. So let me take you through all of the guidance now in a little more detail.

This slide shows the operating profit bridge from 2017 to our 2018 guidance range. The base for 2017 is GBP 510 million, adjusting for foreign exchange and the incremental impact of the 2017 disposals. We expect a positive contribution from trading of between GBP 10 million and GBP 50 million. This incorporates the ongoing challenges in our higher education courseware business, but also an expectation of improved performance in the remaining 70% of Pearson that John referenced in his introduction.

Other operational factors and incentives reduced profit by GBP 30 million with increased investment in strategic growth areas, mildly offset by lower incentives.

Inflation will be a GBP 50 million drag, in line with what we've told you in previous years. The restructuring program that we started last year will generate an additional GBP 80 million of savings in 2018. Taken together, this leads to underlying profit growth and a guidance range of GBP 520 million to GBP 560 million, based on exchange rates, at the end of 2017. The midpoint of this guidance is in line with the median of consensus.

You should note that this bridge includes the contribution of all Wall Street English in Utah, which remain in the portfolio at the start of the year and K-12 courseware, which is now held-for-sale, but for which no disposal has been announced.

The combined contribution of those businesses to 2018 operating profit will be around GBP 19 million. This slide shows how we see our prospects for U.S. higher education courseware in 2018. We simplified the format of the bridge to make the drivers of performance clearer. Digital now includes the full benefit of growth in our digital sales, including inclusive access or DDA deals, rather than the net impact of the digital transition in courseware. That means that the full negative impact on print sales, from the secondary market growth, and our own initiatives to shift from ownership to access models, is all shown in the third bar.

You can see that our underlying assumptions for the market are largely unchanged, although, we do see a slightly lower drag from enrollment of 2% and from OER of 1.5%, based on our experience in 2017.

This means that we expect underlying declines in market demand of around 6% in 2018, a little better than the 6% to 7% we've previously guided to.

We are expecting a further improvement in returns as the channel continues to respond to the actions we've been taking to reduce inventory levels.

We don't have perfect visibility into this area at this stage of the year, so we've given a range for this benefit of between 1% and 6%.

This means we expect sales in U.S. Higher Education to be flat-to-down mid-single digits, overall.

We're expecting growth in the remaining 70% of our business. Let me walk you through the moving parts. In North America, we're expecting stabilization in student assessment and growth in connections, OPM and professional certification. Learning Studio will continue to be a drag, but a smaller one than it was in 2017.

In Core, we're expecting modest growth driven by our recent investments in student assessment and qualifications, where we're offering new products and services of considerably greater value, along with continued growth in PTE and OPM.

In growth, we expect a modest increase, driven by new product launches in English, growth in the Pearson Test of English and more stable conditions in Brazil.

Moving on to our simplification program, which underpins the GBP 80 million that you saw in the 2018 bridge. This slide shows our expectations for the program, updated for the good start that we made in 2017. We're on track to deliver the full GBP 300 million of savings in 2020, though obviously, the precise impact will depend on how exchange rates play out over the life of the program.

Finally, let's turn to cash flow and the balance sheet. As I mentioned in my introduction, cash came in strongly in 2017, despite a decrease in operating profit. Cash conversion was 116%, driven by tight working capital management, lower returns and good Penguin Random House cash dividends, offsetting continued investment in product and CapEx.

For 2018, we'd expect our cash conversion to fall from the exceptional level we saw in 2017, as collections and dividends receivable from Penguin Random House both normalize. You should still model cash conversion at a minimum of 90%, however.

Product development spend will be similar to 2017, but our capital expenditure will fall slightly, as we continue to make progress in our system simplification program.

At the start of 2018, we still have GBP 150 million to spend on the GBP 300 million share buyback we announced in October, and we will also have cash outflows relating to our restructuring during the year.

Putting all of this together, we expect net debt to be broadly level with 2017, before the impact of any further disposals or FX.

You should also note the deferred revenue grew 5% in underlying terms, rising to just over 19% of revenue. However, 2 businesses, Wall Street English and K-12 courseware, together account for more than half of our balance sheet deferred revenue. Excluding those 2 businesses from the portfolio, the deferred revenue balance would have been around 9%.

Stepping back, we do have a very strong balance sheet, and that means the financial strength that allows us to focus on transforming our business. Over the past year, we proactively used cash and Penguin Random House disposal proceeds to reduce our debt maturities and substantially eliminate financing risk. We now have no maturities until 2021, and we've reduced the size of each debt maturity to decrease refinancing risk.

Our capital allocation policy remains unchanged. We will: One, maintain a strong balance sheet with the solid investment grade credit rating; two, continued to invest in the business organically; three, maintain a sustainable and progressive dividend; and four, return any surplus cash to shareholders.

And with that, I'll hand back to John.

John Joseph Fallon
CEO & Executive Director

Thank you, Coram. So last year, 69% of our sales, as you see here, came from digital and services, which is the measure that we've been tracking over the last decade or more. We're now at the point where we think it'll be helpful to unpack this metric, so that we can all track our digital progression more clearly as you can now see on the right-hand side of the slide.

So 32% of our sales last year came from products and services consumed in purely digital form. Virtual schools, online degrees, online homework and assessment platforms. 27% came from digital enable products and services that combine the digital and physical world. So good example of that would be Pearson View, which delivers computer-based testing, but in physical centers. And then the 41% of our sales, although, nondigital, includes textbooks, but it also includes those 10% of nondigital services businesses, such as Wizard, our English Language franchise business in Brazil.

Just to stress, these nondigital products are still very important to many of our customers and they have real value. They will continue to be an important part of the revenue and profit mix for Pearson for some time, and perhaps, forever. But as we make good progress on our strategy, the weight of our sales will shift steadily to the digital and digital-enable categories. And this will make Pearson a growing, sustainable profitable company with a more reliable and predictable revenue and cash profile.

Our customers are a mix, as you know, of students, educators and administrators. They all see that education has to evolve, to meet the changing needs of a world of employment and skills. It is going to look radically different from our children than it did for us. And our move to digital is all about meeting that need. We help people to teach, learn and grow in new and powerful ways, by using our scale and expertise to deliver better learning, more personalized, more flexible, more engaging with better outcomes, delivered with anywhere, anytime, technology that gives people the freedom and the flexibility they crave and the control over when and where they learn. And real-time, personalized feedback that supports teachers to help learners to focus on what they really need to achieve.

We achieved the benefits of this digital shift by combining our expertise in content and assessment, with the strength and the relationships we have with educators, to power the 3 strategic priorities you see on this slide: Drive the digital transformation of our courseware and assessment businesses to grow share; two, build our businesses in those structurally growing markets more quickly; and three, make Pearson a simpler and more efficient company.

So let's take a look at how these priorities play out in the businesses that now make up nearly 80% of our revenues, and profits, as you've just seen from Coram's profit contribution analysis. I'll take you briefly through the highlights of what we're doing in each. There's much more detail on the slides and in the appendix to the presentation, which should help you.

U.S. higher education courseware accounts as you heard from Coram, were just under 30% of our revenues and our profits. Half of those revenues are already digital. And we're expecting that to increase to 75% beyond 2020. We serve 3 interrelated customers, students, faculty and administrators. They all of value affordable choices and outcomes, but they value them in different ways, and we are meeting the needs of each group by changing our business model, from ownership to access, by shifting to more institutional and consumer channels, by accelerating digital formats and by investing in better learning experiences and outcomes.

Now, it's good to see that our competitors are now following our lead to a greater or lesser degree. And the reason that's a good thing is because the quicker the industry as a whole moves to a digital-lead access model, the better that is for all stakeholders, especially students. But a winning sustainable strategy needs to recognize that the specific needs of all 3 customer groups needs to be met, students, faculty and college leadership. And that they all care in their different ways about all 3 things, affordability, choice and outcomes.

Now in a January last year, you remember that we set out our plans to scale rapidly lower cost, subscription access business models to offer affordable choice with better outcomes. And you can see from last year's results that those plans are gaining traction. In our Inclusive Access model, students benefit from discounted prices. Day 1 access drives better outcomes for all, through campus integration. And Pearson benefits because we get 90%-plus sell-through, gaining share from the secondary market and from nonconsumption. We now have students at 425 colleges who last year took over 1 million Inclusive

Access courses with Pearson. And we expect to scale the number of colleges and the number of courses rapidly this year.

Our digital rental model is now the most affordable option for students, is priced more competitively than print rental. And this, again, is helping us to win back share from secondary and nonconsumption. And our print rental model offers a competitive price for those, and there are still some who prefer a printed text. For Pearson, the benefit is that it eliminates, again, the future secondary market. And that's why in our model, we do not allow any other print options than the print rental model. We're scaling this model too, as you can see, in our announcement. But we're doing it carefully, respecting the concerns of faculty and authors and working with them as we do so. Because that's the best way to get traction longer term.

Now we'll continue to flex our offerings as the market evolves. There are no simple headline-grabbing silver bullets here. What you're hearing though is that we're going to focus on a coherent and consistent way of meeting the needs of students, of faculty and of administrators for affordability, yes. But for choice and better learning outcomes as well.

Now offer offering learners more affordable choices, as you've heard me say, helps us to grow because it expands our addressable market. It closes that gap between use and value that we've talked about before. But we will also grow by getting more faculty and students to use Pearson courseware, and we do that by improving the student experience and enabling better learning, and we're doing that in 3 ways: One, really exciting pipeline of new products that are coming to market now and will continue to use do that over the next 2 years; two, the deployment of the new global learning platform, which will just enable us to innovate faster and scale much more rapidly and reliably; and third, by investing in the services, such as analytics, faculty support, seamless integration that college leadership value most and are fundamental to making these new business models work.

So let's now take a look at how our priorities play out across the rest of Pearson. For each business, the slide will lay out the markets, the opportunity and the competitive advantage. I'm not going to take you through the details of each. I'm going to keep my commentary quite high level. We're going to start with our school assessment businesses, both in the U.S. and here in the U.K., where digital transformation is enabling us to better meet the needs of students, teachers and administrators. Together these businesses account for around 16% of our revenues. They have, as you know, been through some difficult times around policy and curriculum change in recent years, but we're now through that. We've continued to invest and we're well positioned now to grow again in this markets as they stabilize. In the U.S. we are still the largest vendor. We've led the shift towards digital testing, with our best-in-class platform, TestNav, digitally administered test, now account for well over 50% of the total, and that digital lead is allowing us to develop strong partnerships. And through those partnerships produce our own regulatory risk.

In the U.K. we're also pioneering the shift to a more digital future, building on our innovative online data analytics tool, ResultsPlus, which is making access to marked exam scripts available online, free to every student, every teacher and every school in this country. And in both markets, we're leading the adoption of artificial intelligence in assessment to support better learning, providing real-time personalized feedback, of which ResultsPlus is a great example, which supports teachers to help learners to focus on what they need to achieve to be successful.

This digital promise of anywhere, anytime learning also opens up 2 of our biggest structural growth opportunities. And that is to partner with charter boards to run virtual schools and to partner with universities to offer fully online degrees. Both markets are still relatively earlier in their development. And we've seen some shift in contracts in some of the early adopters in service, some services or insource some services, or try to go it alone. We're learning from that, and we're learning that we need to adopt our own offerings, which were some of the first to market more quickly to meet the changing needs of our partners and that's what we're doing. At the same time, we're developing new Core skills for Pearson that we can then deploy across the whole company, around digital marketing, around student recruitment and retention. We're scaling online learning in a way that focuses on outcomes, providing, again, better learning, anytime anywhere, anyway with personalized feedback that supports that retention and reduces churn that in time, of course, makes for a better and profitable business model.

Today, these businesses account for just under 13% of our revenues. The investment required to scale these businesses more quickly, which are now well placed to do, with some really exciting partnerships in the pipeline, means, as you heard from Coram, they won't make much of a contribution to profits, short-term, but they will drive long-term growth in revenue and profitability as they mature, and over time, became a much bigger part of the Pearson portfolio.

In the meantime, more immediate sales and profit growth will come from 2 businesses that make up over 20% of our revenues today: Professional certification, where our customers seek the credential that opens their way to a better job; and learning English, which opens up the opportunity to live or study in another country or work for a global company.

The first year of our new American medical colleges contract is the latest in a long series of big wins, the Pearson View, 50 new contracts signed last year. And that extensive network of centers that supports those contracts is also the platform that has powered the exceptional growth of the Pearson Test of English.

Pearson Test of English is more convenient than its rivals. You can take it at any time. You get the results more quickly than from any other tests. It provides much more personalized feedback, and is actually also a more accurate assessment of ability of all 4 skills for those relying on the results of the test.

Our ownership of GEDU and Wall Street English taught us a lot about running direct-to-consumer, brick-to-mortar ELT businesses, and we're putting those insights to great use in both China and Brazil, as we now can able to power a wider range of partners who are very keen to deploy our brands, our content, our assessment and capitalize on our expertise and ability to scale online.

So those are the primary ways in which Pearson will grow over the next few years. Increasingly, these products and services will be delivered across common platforms enabling a leaner Pearson, driving significant revenue and cost synergies. Those synergies are enabled by a third strategy priority, which is simplification. As you can see, on the chart, we've made good progress over the last 5 years in making Pearson a simpler, leaner, more efficient and scalable company, but we're not letting up. We are well on track to take a further GBP 300 million of cost out of the business over the next 3 years and that, combined with the growth opportunities we see, means that we're now well-placed to get Pearson overall growing again. As we accelerate our move digital in a more sustainably profitable and scalable way, with a more reliable and predictable revenue and cash profile.

Right across the company, we have talented and committed colleagues who are all very excited by the fact that our ability now to deliver more effectively, on what has long been Pearson's mission, to empower people to progress in their lives through learning is what will drive our future growth.

And so with that, Coram, the executive team and I will be very happy to take your questions. To help answer your questions, we have here, Tim Bozik, who leads on Global products; Rod Bristow, who leads in our Core geographies; Kevin Capitani, for North America; Gio Giovannelli for our Growth Markets; and Albert Hitchcock, for Technology and Operations. Bob Whelan, who leads our North American Assessment businesses can't be with us today because he is at a major customer event. But we also have with us completing the executive team, Kate James, who leads our Marketing And corporate Affairs; Jonathan Chocqueel-Mangan, who has joined us to lead on Strategy; Anna Vikström Persson, who has joined to lead on Human Resources; and Bjarne Tellmann, our General Counsel.
And with that, let's go into Q&A. So where are we going to start? Should we go here and get a microphone there?

Question and Answer

Katherine Tait
Goldman Sachs Group Inc., Research Division

Katherine Tait from Goldman Sachs. If we just dig into OPM a little bit more, clearly it's been a big focus of some of the Investor Day presentations that you've done over the last couple of years. And if we just look at the numbers, I mean, in 2016, and clearly, enrollment growth of 19%, I think, in a double-digit revenue growth. And so this year, 2017, perhaps a little bit more disappointing at the sort of 3% revenue growth levels and 8% enrollments. And then also looking out further into your outlook statement talking again about, sort of, modest growth outlook there. Can you sort of a marry that up with the broader market outlook that you just put up in terms of the 10% market growth? And I appreciate that you are the market leader in the segment. But if you could, sort of, explain some of the reasons for the contract exits? And perhaps some of the smaller contract restructurings as well? And what sort of drives your view into how you can continue to lead in that market?

John Joseph Fallon
CEO & Executive Director

Good question. I'll ask Kevin to give a bit more color. Just before he does, 3 points I've made just my way of introduction: First, we were first to market in this business, 7, 10 years ago. So we're then also the first to have to deal with big waves of contracts as they come up for renewal after that 7 to 10 years. I think we've learned a lot through those first waves as Kevin will explain, and I think you'll see us get much better at contract renewals over the next few years; second, I think we're excited by the pipeline we see in the graduate market, which is the established market today, and again Kevin will talk about that; and third, we're just starting to see the emergence of what's sometimes called the enterprise or the undergraduate market, if you think about it, given the changing nature of higher education, that as a potential to be many times the size of the graduate market, we're the only people who scale that so far, which we've done in partnership with Arizona State University, and we've got a second very exciting partnership coming up with Maryville. So 3 reasons to put it in context, but ask Kevin to expand and give a bit more color on it.

Kevin Capitani
President of North America

Can you hear me? Do I need this?

John Joseph Fallon
CEO & Executive Director

You need it because everybody is listening online. So just...

Kevin Capitani
President of North America

I hope I can expand on the all these things, John. First and foremost, if you look at -- to answer the exit, if you look at Boston University, which we've had a 16-year relationship with, they're exiting and it's not uncommon in a managed services business that over a period of time that companies, institutions will take things back, that should be normal. And it's something that we're planning for and accounting for. In a business context what you have to do is have a very strong pipeline, and we do, 3x sometimes and 5x now, to use that terminology to combat that. And basically you need to stay ahead of that, and we're well ahead in terms of pipeline, both in our Core and our graduate market. But the undergraduate and the enterprise market that John referenced. So as we plan for those things, we're going to see contract exits or we're going to see take it in-house. What we don't see is losing the competition, at all. So we're planning for that really, really well. I think that some of the contracts and the renewals that we're going through, not only is it strong, in terms of getting all those renewals, but in terms of expansion that we're going towards. So that's something that you'll see. I don't think that the pipeline has been ever this strong since we bought the business 5 years ago. So we're really bullish on this. The thing that Coram mentioned is important, in the investment when you start new programs, you have a 2-year to 3-year ramp to get that profitability or get that contribution. And we're in that cycle right now with a strong pipeline. So in '19, you'll see great growth in terms of signings and new programs. But in terms of contribution, that doesn't take place until '20 and '21 with regards to those. So really, really strong on our pipeline. Two things I will mention in addition, I want to expand a little bit. If you look at the undergraduate market and the enterprise what we're calling market, with Maryville and ASU, that's a growing market. And there isn't anybody else besides us in terms of our competition that can scale that rapidly. And what we can do. So you're going to see a lot of additional programs in the Maryville. You're going to see an uptick and additional programs enter ASU. And then we're going to scale appropriately with the next 2 or 3 enterprise undergraduate, as that market starts to form. What we really like about that market is the average time for a student or an enrollment to take place is 3 to 4 years, versus 2 on a graduate program, so the revenue is longer, and the student acquisition costs are less, which is really, really beneficial. And nobody else can do that but us, in terms of our capability and strength.

Katherine Tait
Goldman Sachs Group Inc., Research Division

And just a quick follow-up. And is that -- if I think about the investments that you have to make in terms of these undergraduate courses versus the graduate courses. I mean, is there a big difference in terms of the investment levels required?

Kevin Capitani
President of North America

For the undergraduate, it's actually a little bit more turnkey. It's more simple. We actually have some courseware synergy that we can take advantage of there versus the graduate market, which is kind of a bespoked lecture oriented without the courseware. So there's better synergy, both with the marketing and student acquisition. And there's better synergy with the courseware that we're really positive on. And if you look at our competition, nobody has the scale or the breadth, or the portfolio on the assets that we do.

John Joseph Fallon
CEO & Executive Director

[indiscernible] and the microphone behind you.

Simon Baker
Societe Generale Cross Asset Research

Simon Baker, Societe Generale. So three questions, please. One, could you just confirm that none of the 2020 GBP 300 million cost savings are somehow interrelated with the K-12 U.S. courseware business? I guess, not but could you confirm? Secondly, on the use of surplus cash, I appreciate the pyramid of balance sheet strength and investment then steady dividend growth then returned to shareholders, what's the, sort of, time line on a U.S. K-12 courseware disposal before you get to the fourth element, the return of cash to shareholders in surplus? And then finally, on the slightly low -- lower drag from enrollment and OER, can you just put a little bit more color on what you're seeing that's -- that you're referring to there, please?

John Joseph Fallon
CEO & Executive Director

Okay. I think, Coram, do you want to pick on the first 3 -- first 2 or 3 points. And then Tim will pick up on what we're seeing from an enrollment and an OER point of view.

Coram Williams
CFO & Executive Director

Sure. So on the first question, just to confirm, there is no interconnectness between the GBP 300 million of savings relating to our simplification program and the K-12 disposal. We have been running K-12 as a separate entity for a period of time. And therefore, it's contained, and we will manage any stranded costs as a result of that exit, so no relationship there. In terms of the use of surplus cash, Simon, you're absolutely right in terms of the pyramid. I think it's a little premature to start speculating about what excess capital there might be and therefore what we might do with it, given that we haven't close the transaction in Wall Street English, and we've only announced today that we're in a process for K-12. But I think the board has demonstrated an appetite to return excess capital, if its' there, but we can't speculate just yet just to whether or not if we'll be there.

John Joseph Fallon
CEO & Executive Director

And just to sort of manage expectations, unlikely processes remind everybody what the profit contribution from that K-12 business is.

Coram Williams
CFO & Executive Director

Good question, John. I just -- I mentioned in my presentation that it's GBP 19 million relating to K-12 and Wall Street English, of that GBP 11 million of profitability in 2018 related to K-12. So I think you have to think about that number when thinking about proceeds from the disposal.

John Joseph Fallon
CEO & Executive Director

Okay. And then, Tim, do you want to give a flavor of where we think we are from a cost enrollment perspective and also the confidence we have in where we think the impact of OER will be as Coram called it on the chart?

Tim Bozik
President of Global Product

Right. So the -- our assumptions about the enrollment are reflected in the model that Coram shared. I mean, I think, our -- to share a little bit more about the enrollments, we saw some modest improvement enrollments as reported last fall. We think sort of long-term they are going to be a function of demographics largely as well as participation. We think we've factored that in appropriately to our model. And as you know Pearson is weighted to adult learners. And so the sensitivity to adult learners may be reflected in that. We're pretty confident in our enrollment outlook. And so far, it can be precise. From an OER perspective as well, I think we're quite close to the OER environment, because we're quite close to our customers. And to some extent, it's a reflection of the concerns for the value the customers place, as John said, about affordability. But they also place very high value on outcomes and choices. So we think that our responses both in terms of go-to-market perspective and the things that we're doing from a product perspective to deliver products that can support better learning outcomes positions us very competitively and well for the impact of OER in conjunction with the things we're doing from an affordability standpoint.

John Joseph Fallon
CEO & Executive Director

Okay. And for our British audience, just to remind you, that was an American use of quite. So it actually means very close. So just to make sure that we are all understood what Tim was saying.

Okay. Next question here from Chris. Can you turn the microphone over?

Christopher Anton Giles Collett
Deutsche Bank AG, Research Division

It's Chris Collett from Deutsche. Just a follow-up on Coram's very good question about the contribution from K-12. I think the GBP 11 million was the -- that's after allocation. So the contribution to profitability -- is that more like about GBP 40 million -- GBP 30 million, GBP 40 million? But just give us that number. And then so just to follow-up on -- one was on the MyLabs, sort of slow decline. Just wondering what we should expect there. And then thirdly, within growth, so South African textbooks, got a big -- looks like quite a big contribution, but it's quite lumpy. So should we expect that to go down again sort of in the future before bumping back up in kind of years to come?

John Joseph Fallon
CEO & Executive Director

Okay. Coram, do you want to pick up on the first of those questions?

Coram Williams
CFO & Executive Director

Sure. I think, I've said in previous presentations that the contribution margin on K-12 is high-single digits on a sales base, which is a little less than GBP 400 million. So Chris, you're getting to roughly the right number. But the GBP 11 million is the right number to focus on, because that is the profit that we will lose as a result of the business leaving the portfolio.

John Joseph Fallon
CEO & Executive Director

Okay. On the -- on MyLabs and registrations, I mean, as you can see, last year has played out as much as we called it, about 18 months ago, which we're seeing good growth in digital revenues as we add new features and functionality to the MyLab and mastering products, but they are at the top of the S curve from a maturity point of view. So growth in registrations is very dependent on the pipeline of new products and features coming through. So Tim, do you want to talk about our -- the regions for our growing excitement about that pipeline and how that will drive registration growth in the future?

Tim Bozik
President of Global Product

So I'm super excited about our pipeline, and John will [indiscernible]

John Joseph Fallon
CEO & Executive Director

[indiscernible]

Tim Bozik
President of Global Product

Yes, not quite super. You're correct for other American English differences. First of all, we're seeing very strong growth in our Revel product. It's at over 50% volume growth year-on-year. It's growing because it does the things our customers care about, which is deliver better learning with real-time feedback anytime, anywhere. It is a textbook replacement model. It provides an integrated learning experience. It delivers a killer mobile experience that our customers love. Its app store ratings are in the high 4s out of 5 from our students and provides a better learning experience, which is what -- because it's designed on what we know about how the students learn, and it's designed to deliver that in a sort of fully integrated digital fashion. That's indicative, I think, of the R&D and pipeline that will drive further volume and share, and therefore, commercial value out of that. I'd like to share sort of one particular point from an R&D standpoint. We've been applying artificial intelligence and machine learning into very important foundational areas in learning, in mathematics and in writing. And we're doing that in ways that allows students and faculty or teachers, not only to get feedback in a sort of learning and assessment experience of what they're doing, but how they're doing it. So that means in a mathematical perspective, how they're solving a problem and the evaluation of step-by-step, not just a simple answer. From a writing perspective, not just sort of the outcome, but how they demonstrated reasoning into this -- into writing mechanics. These are activities that are in testing with customers now and I think will bring really the next big breakthrough in learning and product value to our customers and will drive sort of future growth in both volume and for our business.

John Joseph Fallon

CEO & Executive Director

Thanks, Jim. And you will then hand the microphone over to Gio. And Gio, talk a little bit also about how we've seen the outlook for South Africa this year and talk more generally about the business.

Giovanni Giovannelli
President of Growth Markets

So back to John's point there. Part of our business probably will take time to turn to digital, and maybe as John said, will never turn to digital. The South Africa K-12 textbook market is a very solid business for us. We're very pleased with it. It is indeed as you've said, a cyclical business. So as you correctly pointed out, this year's numbers were helped somehow by 3 exceptional orders that we had from provinces in South Africa at the end of last year. The way this business works, is as you know, we have relationship -- long-term relationship with the provinces in South Africa and they order books. And this obviously depends on a government procurement process, which is cyclical. But all in all, the market is still not at its peak. The peak was in 2013, and then it fluctuated. So yes, we may have some ups and downs, but it's a solid business, pretty much like other businesses we have in the growth markets. I was recently with the CEO in China, we have a lot going on there as well.

John Joseph Fallon
CEO & Executive Director

Okay. Thanks, Gio. Next question comes from Ian here.

Ian Richard Whittaker
Liberum Capital Limited, Research Division

Ian Whittaker from Liberum. Three questions, please. First of all, just in terms of sort of average revenue per enrollment that used to be, so the chart that we would get into the U.S. higher education, sort of in terms of sharing that sort of wide world structure problems in terms -- if that was sort of holding out very well? Now I think 2016, that was sort of in the appendix. It looks though it declined to 87. 2017, it actually disappeared from the presentation at all. Just wondering if you could actually give us what that number is now, and then also as well whether you still see that as a valid metric. So moving forward, can you actually explain sort of the -- the sort of structural nature of the market? And the second thing is just in terms of -- I guess a point of clarification. I think, Coram, you said 70% of the businesses growing in terms of revenue. It's just -- but that includes testing which is flat. Obviously, you've got Learning Studios, which is also sort of coming down as well. Sort of on an underlying basis, if you take out K-12, is it probably more the case of the 45% of the business is flat to down with only 55% growing? And then third of all, just in terms of OPM as well, just coming back on that. So I think the sort of commentary was that sort of 2020, 2021, we should start to see the revenue growth coming through some of these new contracts coming through. The sort of implication would seem to be that 2019 -- just as '17 and '18 have underperformed the market, but it sounds like 2019 will also -- you'll also underperform the market growth in OPM as well, because you won't get revenues from these new contracts. So just wonder if you could comment on that as well, please?

John Joseph Fallon
CEO & Executive Director

Okay. Do you want to pick up on the second of those points, Coram? And I'll pick up on the other 2.

Coram Williams
CFO & Executive Director

Sure. I think we're really clear in that 70% of the portfolio is growing. And just to remind you of some of the things that are driving that, the virtual services business, connections and OPM, our professional certification business, you're seeing stability in our student assessment business in the U.S. And in the U.K., we're expecting growth in our qualifications business here as well as growth in Pearson Tests of English and OPM. And you've heard the excitement that Gio has in the great market. So I don't fully understand the numbers you're quoting at me. I think we are clear that 70% of our business is growing, and you can hear the drivers.

John Joseph Fallon
CEO & Executive Director

Okay. On the first point, our actual net revenues last year were up. So if you take gross sales minus actual returns, our net sales were up. And as you heard, enrollments were down. So dividing one by the other means that revenue per enrollment started to recover last year. I think we've stopped showing that measure, because, I think, it is true as we work through the structural change, making sure that it's a measure that really we can all be confident off on a year-by-year basis. It's something we can work through. But I think the important point to remember is where the point now where -- our biggest competitor is actually second-hand sales of our own textbooks. So as we move to inclusive digital models, as we move to digital rental models, as we move to textbook rental models, what we're actually able to do is deflate the cover price that you can track and follow, but we inflate the sell-through. And as a result, I think, what we're now seeing is that revenue per involvement will start to grow. That's a win-win for us, for students, for administrators, and more generally, for the market. And this also becomes an much more reliable business because they haven't then got -- which is the big challenge we've had in the last few years. Those numbers that we were showing previously distorted by the fact that we've got millions of textbooks sat on the shelves in college bookstores or in inventory warehouses around the place. So really cleaning out that inventory in that channel and moving to a much tighter, more flexible model where we sell much more direct to students and much more direct to institutions. It all gives confidence we've got that more flexible business. And then on sort of OPM, we are the market leader. Clear point you need to understand is we are at a an earlier point because we were first to market. We're first to have to renew contracts, so I think a better measure of performance is what's happening to enrollment growth, what's happening to new contracts, how we're growing and expanding the market. And I think, as you heard from Kevin, we are very confident in that. Well, Kevin, I know you want to say more about the competitive performance and the outlook for the business.

Kevin Capitani
President of North America

Just that -- maybe rehash or echo what I said earlier. With our existing core partnerships, it's really strong and great profitability. And expansion of those programs within those partnerships and those customers will lead to good growth. What I was referring to in terms of wait to see is more of the enterprise market and how we need to invest in that to get that type of growth in the '20, '21 timeframe. So you're going to see growth in this market better than it was this year. You're going to see better contribution and profitability as we concentrate on student acquisition within that core. Further -- and it's really an important, we're looking at and selecting programs and new partners or customers based on what we know the highest demand is. So not so just opportunistic, but what are those disciplines and what are those programs within those existing customers where there is demand for those jobs and having that be a lot more profitable, efficient on both ends, the acquisition as well as the, say, the margin and profitability.

John Joseph Fallon
CEO & Executive Director

Okay. We'll go to Thomas Singlehurst next. Thanks, Tom.

Thomas A Singlehurst
Citigroup Inc, Research Division

Sitting in the wrong part of the room. I do apologize. I had -- I want to ask another question about OPM. So I apologize about that. But when looking at the market, it strikes me that when you look at some of the big competitors, one of the differences is they are potentially a lot more aggressive in terms of what they're committing to in terms of student acquisition. And as a consequence and as you've said might prove not to be right. But as a consequence, they appear to have better retention capabilities, i.e. the ability to rollover deals. Now the point I wanted to ask about was, obviously, committing more on student acquisition means more upfront cost, which means potentially more capital. So I was just going to ask, I know it's a core part of your potential growth longer-term, but what -- have you considered the potential of floating the OPM business to get access to direct capital for that business?

John Joseph Fallon
CEO & Executive Director

I think that we believe that we are, at this point, the best owners of that business. We think that there are growing revenues synergies and cost synergies with the -- on the graduate market for the reasons that -- the reason that Kevin explained. And I think also we do want to grow the top line of that business as aggressively as possible. But we also want to grow it in a sustainable way. And we're not looking at this in a 1-year or 3-year view. This is a business that will be the foundations of the future business. So we're doing this on a 5- to 10-year view. So the commitments we will make to our customers are the commitments that we are confident we can deliver on and they're the ones that actually make rational economic sense in terms of the level of investment that we're willing to make and the belief that over a 7-year contract, we're actually going to make a reasonable return on that investment. So I think we feel that we've got the right balance, and it is really important to take a long-term view and to see this within the overall context of the portfolio and the revenue and cost synergies that it will bring over time.

Thomas A Singlehurst
Citigroup Inc, Research Division

I've got one other follow-up, which -- I can't remember Coram said if the early feedback from offers and faculty on some of the alternative models, what -- you're saying that offers -- you had to be wary of offers and faculty when thinking about alternative models. And I suppose you're alluding to the same gauge on limited model coming down the pipe. So can you just give a -- share any insights on early impressions of that model?

John Joseph Fallon
CEO & Executive Director

Yes. Let Tim pick up on it. I mean, I think, we always think it's more important to focus on doing things rather than talking about things that you might do. So both on the inclusive access model and the print rental model, these are the things that we've really worked hard to operationalize over the last 2 or 3 years. And the reason why you pilot them before you scale them is there's always going to be operational kinks and things that don't work for when you need to work through. And one of the most important things we're making both on inclusive access model and a print rental model work is it has to work for the student, it has to work for the administrator, and it also has to work for the author as well. So Tim, I don't know if you want to say a little bit more about that as we roll these programs out.

Tim Bozik
President of Global Product

Sure. So in addition to the -- a fair amount of operational complexity that John described, and we've been doing this and we're iterating and learning and scaling. The particular point John raised about authors and stakeholders and higher education are a very important one. Authors are also educators, so they're both customers as well as sort of product creation partners to us. And this is significant change for them as well. So I think we've been successful in both communicating to them, why we're doing what we're doing, getting their buy-end along the way and their support for doing it at greater scale. And so they have credibility with each other. So we think the steps and the pace that we're taking has put us on a path to do this as quickly as possible and as practical in order to keep our stakeholders with us.

John Joseph Fallon
CEO & Executive Director

Okay. Thank you. We'll go to Sami at the back of the room, and then come down the front. We'll go to Sami first, and then I think I should have said at the outset, if there's anyone listening online who has questions that they want to ask, please post them, and we'll take those as well. But Sami, over to you next.

Sami Kassab
Exane BNP Paribas, Research Division

I'm Sami at Exane. And I'm sorry I missed the earlier part of the presentation. So hopefully my questions are not out of date. But 3 questions as always. Can you discuss the rationale of selling the U.S. school textbooks courseware business and yet keeping the other assets in the other geographies and whether selling one and keeping the other might have some de-synergistic effects? Secondly, BTEC registration, any outlook as to whether we can expect a return to growth in that segment? I think Coram mentioned qualifications a second ago. But is qualification BTEC only or is it...

John Joseph Fallon
CEO & Executive Director

Yes, just getting on that.

Sami Kassab
Exane BNP Paribas, Research Division

And how much revenues did you recognize from Learning Studios in '17? Am I right to think there won't be any Learning Studios revenue in '18?

John Joseph Fallon
CEO & Executive Director

Okay. Coram, do you want to pick up quickly on the third of...

Coram Williams
CFO & Executive Director

Sure. I think I mentioned in my script that we had a drag of about GBP 12 million relating to Learning Studio as it declined. That was roughly half of the remaining revenue, so you've got a similar decline coming in '18 and a little bit in '19. But by then, it's 0.

John Joseph Fallon
CEO & Executive Director

And the rational, I'd ask Rob to pick up on BTEC registration and the outlook for the U.K. more generally in a moment. On K-12, of course, we're -- I think we talked about it back in the summer. This is a business that is a much slower on the digital transition. It is one, as you heard from Coram, one of the lowest margin and least profitable businesses in the company, and it requires significant capital investment in print-led programs that have very little synergies with the rest of the company. Whereas, the rest of our school textbook publishing businesses are higher-margin, require less capital investment. And they also ensure that we retain a platform for as and when there is an opportunity to lead digital transformation. We have other means and other platforms by which we can do that in the U.S. school market, because we have a strong profitable digital-leading assessment business. We have a very strong virtual schools business. And you remember, we're also retaining both the advanced placement and career and technical education part of our K-12 business. So I think those are the reasons why the circumstances of the K-12 school publishing business in the U.S. are very different from the rest of the company. And then Rod, do you want to pick up on where we are on BTEC registration and the wider outlook for the U.K. qualification?

Kenneth Roderick Bristow
President of UK & Core Markets

Yes. I will. Thanks for the question. I think if I was an American I'd say I'm quite excited about the prospect of the growth that we have in qualifications. It is true. In the last few years, we have been impacted by education policy changes that have affected the size of the market that we work, and it's particularly impacted on BTEC. But I'm pleased to say that our BTEC registration stabilized last year, and we'll recognize those revenues during course of 2018, because of the revenue recognition model. I'm also pleased to say that as a result of the investments that we continue to make into qualifications these last few years, we have a more valuable proposition to put before our customers, and I think we'll see the benefits of that coming through. And then I think to your point about K-12, more generally, in the U.K., our strategy is to create a kind of an ecosystem, if you like, of learning around our qualifications to support our customers, teachers in delivering those qualification. And we are seeing the benefits of that in terms of our ability to gain market share, for example, in GCSE Science where we saw a tremendously strong reaction to the ecosystem that we put around our GCSE Science qualification. So I feel very positive about the future.

Sami Kassab
Exane BNP Paribas, Research Division

Okay. And just rapidly, did you disclose the rate of revenue growth or decline of the K-12 assets to be disposed of last year?

Kenneth Roderick Bristow
President of UK & Core Markets

We said that it was a decline based on the back of Open Territories and adoption markets. I don't think we put a precise number, but you should assume it's mid-to-high single digits.

John Joseph Fallon
CEO & Executive Director

And then we'll go over here.

Matthew John Walker
Crédit Suisse AG, Research Division

Matthew Walker from Crédit Suisse. Just a couple of things, please. The first is you showed higher education courseware, I think it was like 28%, 29% contribution. Including central cost, what is the percentage share of operating profit of higher education courseware? Second thing is on inventory. And we saw a huge change in inventory in '16. And I know there's a range of around 8% for potential outcomes on inventory in '17. It turned out to be only 2%. Some of your competitors have said that it was actually a much bigger reversal in '17. So can you just explain why it was so little? And going forward, again, your outlook first sort of 0 to minus 5 in higher ed, so the entirety of which could be moving 1 -- from 1 extreme to the other purely based on inventory. So why is it so difficult to work out what inventory is going to do. That seems like a really huge range again. And finally, on unlimited, I don't think the -- you sort of quite said how you thought Unlimited was going. Clearly, Cengage would be in a -- upbeat on their call about wherever they call takeaway adoptions or whatever phrase you would use. Why does that model not make sense for you and the higher ed companies, the sort of all-you-can-eat subscription model? Particularly, if you would think that with Pearson -- I think, this Cengage number is 1.1 courses per student. And you would think given Pearson's market share, it will be well above 1.1. And so that kind of model would maybe set better than the DDA.

John Joseph Fallon
CEO & Executive Director

Okay. Well, let's pick up on that last point first. And then Coram will pick up on the other 2. I'll ask Kevin too. But just way of introduction, for the reasons you talked about, that model does work for Pearson. It's called Inclusive Access. We've been doing it for the last 3 years. And we have over 400 colleges signed up through it and over 1 million students enrolled. And it's a fast-growing part of the business and one we're very excited about. So -- but Kevin, do you want to pick up on that and then talk a little bit about how you feel the competitive landscape is shaping up on campus?

Kevin Capitani
President of North America

Sure. Good. Perhaps to be redundant, any type of subscription access model needs to take into account all 3 of the customers. You can't just focus on one. I think with our affordability, we've made great progress. The pricing is in line with what's Cengage Unlimited wants to do from a B2C perspective once that choice is made. Remember that the students choose how to buy, but the faculty still chooses what to buy. And that's a completely different thing that needs to be taken into account. We're there already with the pricing schema from a student perspective with print rental and digital rental. And we're taking away from the secondary market just to say again. Regarding how things are taking place and what's going on, on campus, with our CRM system, we're tracking this daily now. And I have to say that I don't really buy into the claims that adoptions are going away. It's not happening. They are sparking interest. There is conversation, but it leads us back to what we're doing really well, which is taking into account all 3 customers. Daily when I meet with deans, department heads, presidents and provosts, they look at this affordability with table-stakes type set of lenses. And what they're more interested in is really talking about outcomes and the data that can get to, to help bolster enrollments, keep students in the classroom, whether it be online or bricks and mortar, and then outcomes that are associated with that. Dashboards are not new to other industries, but they're new now to higher education. And instructors and administrators are using those dashboards to actually see when the student's not performing well and how they can intervene real time versus those that are doing really well and asking the questions as to why and how can we replicate that and duplicate it. That's a completely different discussion than what Cengage Unlimited has been proposing. And I would take -- I'm very confident in where we're going and what we're doing, that ours is more well-rounded, but the affordability aspect is already there. And then finally, students, students' impressions at Cengage Unlimited sounds great. I like the pricing. However, it would be better if I had more flexibility. I don't need access to everything. I only want to purchase what I need. So it's a big difference. Let's have this discussion again in a year and see where we land. I'm pretty confident that we're going to land well.

John Joseph Fallon
CEO & Executive Director

And so to just build on that last point. If you look at the combination of our digital revenue prices, our print rental prices and our inclusive access, we are already very competitive when a student looks at what it actually cost them to buy that courseware, which is why, I think, we're very confident in where we're at. Coram, do you want to pick up on the operating profit contribution from higher education and this inventory point?

Coram Williams
CFO & Executive Director

Sure. Yes. So -- just to explain why we show you product contribution in the slides, it's because that's the way we manage the business. And that allows us to take central costs, manage them centrally, have real visibility into them. And as you know, we think that those costs are too high, and it's the way in which we control them and will reduce them as part of the restructuring program. So I just want to explain why we look at the business in that way. Having said that, you can see that higher education, 26% of revenues, 28% of product contributions, it's roughly in line with Pearson's overall margins, and it wouldn't look that different if you were to do it on a fully allocated basis. But I do want to be clear how we ran the business. In terms of the inventory correction, I think, John made a point that on an actual basis, in other words, if you look at actual sales and actual returns, then we were up last year. But the key point is that -- and we've said this to you all the way through the year last year, returns were lower than the prior year, but not quite as low as we had expected. And therefore, that meant we have to top up the returns provision to cover ourselves on an accounting basis. So that's why you get 2% benefit on an accounting basis. The actual benefit would have been higher than that. In terms of the channel, we've taken a lot of actions to improve visibility. So we're really focused on the incentivization of our sales staff. We put in place returns, restocking fees, and all of that is about making sure that this channel is under control and that we have as much visibility as we can. But we don't have perfect visibility. We've got 2 more returns periods to go this year, that's why we're giving you a bigger range. We do believe there will be ongoing reduction in returns. But at this stage, it wouldn't be wise to put a narrow range on it.

John Joseph Fallon
CEO & Executive Director

Okay. [indiscernible] fair to say, Coram, in the -- what we're seeing is lower buying orders from the channel of textbooks in December leading to higher digital sales and higher direct consumer sales in

January, leading and return to lower returns in February through to March, which is exactly what we said in January we thought would happen and exactly what is starting to happen.

Okay. So -- sorry, 2 more questions, and then we'll wrap it up.

Giasone Ulisse Salati
Macquarie Research

It's Giasone Salati from Macquarie. Three questions, please. One for John. I'm going to push my luck and say can you -- do you think Trump education policy could actually help Pearson? And by this, I mean, school choice charter, virtual schooling, is that a boost and it's sizable enough maybe longer-term to be a positive? And then on the other side, vocational versus college, is that kind of pushing enrollment down to more favorable end for Pearson, which is the shorter or sort of less sophisticated college? Second is for Albert, I'm always very concerned about this big restructuring in technology because that seems to me everything can go wrong at any point. And we won't know until the last hill. Can you reassure us that so far so good? And on the milestones, maybe give us an example. I think, I haven't heard about the IBM Watson cognitive -- I can't remember the name, but that -- in terms of coming to market? And the third one for Sidney. When you look at the company now, would you be okay spending GBP 1 billion in acquisition? Is the base solid enough that you can actually look at growth M&A?

John Joseph Fallon
CEO & Executive Director

Okay. So Kevin, is President Trump good news for Pearson in our K-12 and vocational businesses?

Why is everybody laughing? It's a good question. It's a good and perfectly sensible question. So -- yes, you do. So everybody can hear you...

Kevin Capitani
President of North America

Do you have guard rails on for this one? Regardless of President Trump's administration in the virtual schools market, the need, desire, pipeline, want is there. So if you look at where we're performing well, in certain states, you look at California, Pennsylvania, Florida, even Ohio with some of the problems there, there is headroom or great enrollment pipeline associated with what we're doing there, regardless of any type of Trump education policy. I think the demand for virtual schooling in that space is going to continue to grow. And the good news for us is the barrier to entry is really hard, given the regulatory environment. And our brand, our success, our efficacy focus in that space is -- puts us predominantly well-positioned to continue regardless of education policy. It's pretty nice to avoid Trump today, so.

John Joseph Fallon
CEO & Executive Director

Okay. I'd tell you what will absolutely help our virtual schools business in America. You remember that 5 years ago we made this commitment that by this year we'll be in a position to report on an externally audited independently verified basis on the efficacy of our products. Well, one of the first studies that we published very shortly will prove that our kids in our virtual schools across America performed, at least as well, if not better, across all subjects as compared with students in bricks-and-mortar schools. So the more we can prove the efficacy of virtual schools, the better we'll do. And that brings us back to the theme of this morning, because virtual schooling is about affordable choice, better outcomes. And those are the themes that are fundamental to the future, the Pearson that we are building. Second question, well, I think, Albert just said yes. So Albert, the one-word answer, yes, it's all okay, but give the longer version of that.

Albert Roger Hitchcock
Chief Technology & Operations Officer

Well, I think the thing to say, that's a very multifaceted program, right? So there isn't some large day that we're all heading for Armageddon, if that was your point. There's been some really good progress made. So just to give you a bit of a flavor that -- so we have a large single instance ERP platform that we're implementing. We're live in the U.K. We went live last year. All of our HR systems have been replaced by that single platform that went into the U.S. last year. We're going live with our U.S. business for finance and operations this year. So it's a multi-milestone approach to the enterprise. In terms of simplification, we've decommissioned over a 1,900 systems to date, 400 of them last year. We decommissioned 19 data centers last year. So we're seeing the fruits of all of that simplification, and that's coming through the GBP 300 million cost-reduction plan. And in fact, technology and operations are a very large percentage of that plan. And all of that is going through today. So other flavors I can give you, a whole new content ecosystem was implemented last year, new content offering, distribution, storage, all of that was replaced with new systems, and new e-commerce platform went in last year. We have a new CRM platform. Kevin mentioned we're getting the benefits of that, that went in the last couple of years. Global learning platform, which is our really exciting micro services cloud-based platform that'll host all our content in the future. We are implementing 2 major pilots this year, one in the developmental math product. This year it's going in place in terms of a major pilot. And also Revel, we're going pull the Revel product line on to the platform as well, and that will allow us to innovate much faster. At scale, the platform is infinitely scalable comparable to the best digital services platforms out there in the world today. So we're extremely excited about the digital platform plan. It's going well. It's delivering. We're seeing the cost savings and everything is on track. And I'll let Tim talk a little bit about the IBM Watson.

John Joseph Fallon
CEO & Executive Director

IBM Watson.

Albert Roger Hitchcock
Chief Technology & Operations Officer

IBM Watson. But GLP at its core is built with a machine-learning capability. And so machine learning AI is at the core of our future digital strategy. I'll let Tim talk about IBM Watson.

Tim Bozik
President of Global Product

Thanks, Albert. So specifically, on Watson, we've released our first product for testing last fall, limited pilot. The service was in a sort of couple of chapters of the product, got the signals there we were looking for from that. We are in pilot release with additional products this semester, full semester usage, multiple courses, AB testing, et cetera. We're encouraged by what we've seen so far, and we feel like we're on track and sort of link that to Albert's calling about sort of GLP and the early comments about our organic sort of R&D in applications artificial and machine intelligence. I think we've got a very strong pipeline and we'll have a platform that will allow much more rapid prototyping validation and then sort of commercialization or productization of these kinds of services.

John Joseph Fallon
CEO & Executive Director

And then, I think, Sidney, you've invited to give a view from the board on balance sheet and capital allocation.

Sidney Taurel
Chairman

Thank you. Yes, over the last 2 years, we've been really focused on simplifying the company, getting it under operational control, strengthening the balance sheet, and at the same time, making the organic investments that we need to build our future. With those investments, we are confident that we have the wherewithal and the capabilities to grow in the future. We have one more year of that simplification process to go through. As you know, 2018 is a key year for delivery on our TEP program as well as on the GLP. And it's only when we have this done that we could envisage in the future potential acquisitions. Because I think what we learned in the past was that our ability to integrate those companies was very limited. So we have the wherewithal, but I don't exclude in the medium to long-term future the possibility of inorganic growth. I do not expect this to be large acquisitions, but we will be on the lookout for things which can supplement our organic growth strategy.

John Joseph Fallon
CEO & Executive Director

Okay. And TEP is the enabling program, which is the underpinning finance and planning changes that enable the -- the unlock [indiscernible] further through independent pound of cost savings that we were talking about. Final question, and then we'll call it a day.

Nicholas Michael Edward Dempsey
Barclays Bank PLC, Research Division

Yes. It's Nick Dempsey from Barclays. Just 2 to squeeze in. First of all, in your 2018 EBITDA bridge for trading, you've got GBP 10 million to GBP 50 million. It strikes me that if you look at the range of possibilities for North America higher ed courseware and do a kind of 70% drop-through on that, that's a swing of 40. So are you not flexing the rest of the business at all in there? Is that swinging from GBP 10 million to GBP 50 million all about the range of possibilities of that business? Second question, on your savings target. You mentioned that there's better -- the FX at the end of 2016, so if we mark-to-market, what's that 300?

John Joseph Fallon
CEO & Executive Director

Okay. Coram, I think, those are all for you.

Coram Williams
CFO & Executive Director

Sure. And so -- in turn -- let me take the FX question on the savings first. The only reason I flagged that in my script is, obviously, a chunk of those savings will be generated in U.S. dollar. So I want to highlight that sensitivity. Currently, on the back of the rates that we're planning on, it's still very close to 300. So it's not that there is a hidden message here that we're coming off the 300, that's not the point. It's merely that there is a degree of sensitivity there. In terms of the trading performance, I think the key point is that, actually, we've said that 70% of our business will grow this year, and we've laid out the assumptions for that. That's what drives the range in trading. But obviously, would be offset depending on where we land in higher ed. So it's the interplay of those 2 sets of assumptions that would drive where we land overall, but it's not just about higher ed.

John Joseph Fallon
CEO & Executive Director

Okay. And on that, thanks again for your interest. Thanks for coming. Gio, Tom and Angela are all here, and we're very happy to take your questions, any follow-up you may have in the course of today, but good to see you all. And catch up with.
[Audio Gap]