

SmartMoney

CEO Interview

Not Bound By Tradition

Harold "Terry" McGraw III, The McGraw-Hill Companies

One picture on Terry McGraw's office wall shows a boyish McGraw shaking hands with Ronald Reagan. In another, he's chuckling with Brooke Astor; in a third, he's putting with Jack Nicklaus. There's no room in the crowded gallery for a framed stock chart, though it wouldn't be out of place among his career highlights. Since McGraw took over the family business in 1993, McGraw-Hill has more than tripled revenue, quadrupled profit and secured a 21.5 percent annualized return for investors. Suffice it to say that the derisive cries of nepotism have subsided.

In the past 14 years, McGraw whittled down the conglomerate's 15 disparate divisions to just three: financial services, which includes debt-rating juggernaut Standard & Poor's; educational publishing; and media and information, home of *BusinessWeek* and J.D. Power and Associates.

It's not easy to pilot such dissimilar businesses, and there are some choppy waters on the horizon. The debt-rating business has driven McGraw-Hill's growth, generating 76 percent of the company's profit last year, but the division traditionally rises and falls with the broad economy. More borrowing means more loans to rate. If the economy slows—or the subprime crisis continues—the loan market will tighten. Meanwhile, the educational-publishing division isn't nearly as profitable, and information and media profits have fallen by more than half. In his formal conference room crammed with memorabilia, McGraw talked to staff writer Janet Paskin about the subprime mess, No Child Left Behind and the future of media.

McGraw-Hill has financial services, textbook publishing and magazines. What's the connection?

The world is growing up. If you are trying to achieve economic growth in your country, you are going to need access to capital, a skilled workforce and clear information. Those are the markets we're in.



Terry McGraw streamlined the family publishing business and put the focus on financial services.

You've said there are synergies in those businesses. Can you be more specific?

We have a shared-services model. Human resources, legal, accounting—you can do those more efficiently.

But investors wonder if each business would perform better separately.

A lot of institutional investors prefer pure plays. From my standpoint, the breakup question is one of performance. We've split the stock three times since 1996; we've returned \$7 billion to shareholders from dividends and share repurchases; we've increased the dividend every year for 34 years. I believe we're doing well.

The financial-services division is doing particularly well, but what happens to Standard & Poor's if the subprime market weakens further?

It's not a problem. I feel badly if somebody lost his home, but the financial impact on us is not major.

You tightened ratings on subprime lenders more than a year ago. Why?

You couldn't watch television without seeing some silly ad that said, "Have no money, have no credit, defaulted in all your payments? Call us, we'll lend you money!" What the hell is that? So we tightened the requirements on those kinds of lenders.

Given the benefit of hindsight, did you do enough? Did you act soon enough?

That's really hard to tell. Sometimes you say, maybe we should have done that a month ago, or even earlier. But we were responsive to what we were seeing.

S&P and Moody's coexist in something of a duopoly, since most debt needs to be rated by two agencies. Is there any competition?

Standard & Poor's is very different from Moody's. We're alike on the credit-ratings side, but we also provide independent investment research, data and analysis, as well as a variety of indexes.

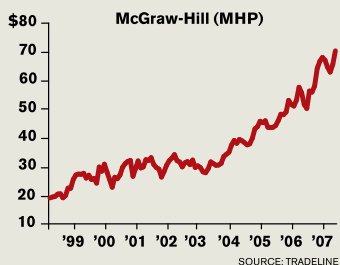
Critics argue that those businesses detract from the profit growth of the credit ratings.

Am I going [to jettison] a 35 percent margin business because it's not growing at 50 percent? I don't think so.

Speaking of massive margins, there are now more than 110 exchange-traded funds based on Standard & Poor's indexes. Each one pays

BREAKING UP IS HARD TO DO

McGraw resists pressure to break up his firm, pointing to the stock's performance.



you a licensing fee that's virtually pure profit.

How many more indexes can you make?

You can set up anything you want. Want to compare banks on a global basis? Want to exclude banks that have assets less than this, or only include banks in the Asian market? I can develop that, and—oh, by the way—I can turn it into investable indexes and exchange-traded funds.

Do individual investors need all that?

You have to be careful—you're not God, and I'm not either. When you're market-based, you're trying to satisfy the needs of your customers. We don't sell to individuals; that's not our business.

Let's talk about education. The No Child Left Behind legislation is up for reauthorization this year. Those reforms standardized curriculum and encouraged testing, which was good for your educational-publishing division. Critics are pushing for substantial

change to the law. What impact would that have on your business?

I see it only getting stronger. We have momentum. If the curriculum guidelines or programs change, so do we. Has everybody benefited? Not yet. But is it on the path? Yes.

You testified in Congress in support of the reforms, but many teachers are against them.

Teachers get all upset: "We're teaching to the test!" Thank God we're doing that. That's a bare minimum. Now you have high-stakes tests with huge consequences associated for the student, for the teacher, for the school. But the real growth is in the low-stakes testing, and we're developing curricula that have those testing tools built in. You can't wait until halfway through the semester to find out your class isn't getting it. After four lessons, three lessons, where are they? So that's where the growth on the testing side is.

Where's the growth in the media division?

The phrase we use here is, all roads go online, and all roads go to Asia.

So will BusinessWeek become dot-com-only during your tenure?

There's always going to be a need for print. I don't foresee *BusinessWeek* as a magazine disappearing, but I do see enormous growth in *BusinessWeek.com*.

Okay...but now you're talking about shrinking profit.

That's why I call it the incubator. We're converting traditional businesses into online and digital businesses. The folks in information and media work very carefully with the educational and financial-services divisions, where we've been successful developing digital product. The whole company was started on one magazine back in 1888, but we have to change with the times.