

## HarperCollins CEO Report November 2009

### Second Quarter Performance

The current estimate for the second quarter is to come in at approximately \$50 million in profit, as compared with \$24 million in the prior year. The biggest drivers being (1) [REDACTED] from the Tolkien settlement [REDACTED] [REDACTED]), (2) the release of the Sarah Palin book (2 million copies shipped in November) and (3) the success of the Children's Division. With the exception of Zondervan, all divisions are expected to meet or exceed plan for the quarter.

### Second Quarter Best Sellers



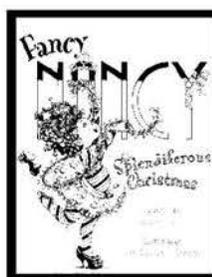
Sales - \$29.0M  
 Units - 2.0M



Sales - \$13.1M  
 Units - 0.9M



Sales - \$5.7M  
 Units - 0.4M



Sales - \$2.6M  
 Units - 0.3M



Sales - \$2.0M  
 Units - 0.1M



Sales - \$1.4M  
 Units - 0.1M

### General Books Business

A very strong list of bestsellers is more than offsetting declining backlist sales. Going Rogue, SuperFreakonomics, The Lacuna, Pioneer Woman Cooks and Pirate Latitudes are all performing better than expected. Additionally strong trade paperbacks continue to be the most robust format with resistance to non-essential hardcover purchases. Ebooks are continuing to grow and are approaching 4% of sales for the General Books group. Our daily backlist and reorder sales rate is averaging 1.3M per day compared to the prior year of 1.4M per day reflecting an overall trend in the industry.

### Childrens Business

The Teen category is one of the few areas with double digit growth prospects and the division is successfully publishing into the genre with series such as The Vampire Diaries. Picture books is a flat to declining market although within the genre, hardcover dominates and our division currently has one of the hottest properties with the Fancy Nancy titles. Backlist remains relatively flat with prior year with the exception of titles connected to a movie such as Where the Wild Things Are.

### UK Business

The UK market remains very challenging and shows little sign of improvement so far in the countdown to Christmas. While backlist is holding up (especially Children's), frontlist titles are struggling, specifically non-fiction titles which have traditionally been the biggest driver of consumer purchases during the Christmas season and the expensive hardcover format in general. How these genres play out between now and then may have a significant impact on Christmas market performance.

### Zondervan Business - Publishing

Zondervan continues to struggle through the second quarter as a result of several titles slipping out of the quarter and a challenging marketplace. Sales for the publishing business are projected at 11.3% below prior year which is similar to industry statistics which indicate a 9.2% drop in publisher's sales of "religion" titles during calendar 09. The Rick Warren title that was expected to publish in November is now scheduled for an Easter release and is forecasted to bring Zondervan's revenues back to fiscal 2009 levels. Next steps for the

business include a plan to rightsize the overhead of the business to reflect a smaller market for religious titles and the completion of the sale of our event business (Youth Specialties) by mid December – a business which has rapidly declined with the economic downturn.

### **Zondervan Business - Digital**

As previously discussed, revenue streams for new digital businesses have been delayed and will kick in toward the end of the fiscal year and into F11. We believe the Zondervan digital strategy, which is to aggregate Christian content as the business transitions from physical to digital, is the most opportunistic path forward. A strategic review session is planned for the first week in December where we may decide to scale back the scope and resources for Symtio, however we anticipate that Biblegateway and TheCity will stay the course. TheCity now has 148 churches under contract, up from 59 in August, which will contribute \$2M in annual revenues once up and running.

### **Full Year Outlook**

With the success in Children's and General Books offsetting the poor performance at Zondervan, we are forecasting to deliver profits of [REDACTED] – hitting the operational plan of [REDACTED] in profit plus [REDACTED] from the Tolkien settlement proceeds.

### **Retail Climate**

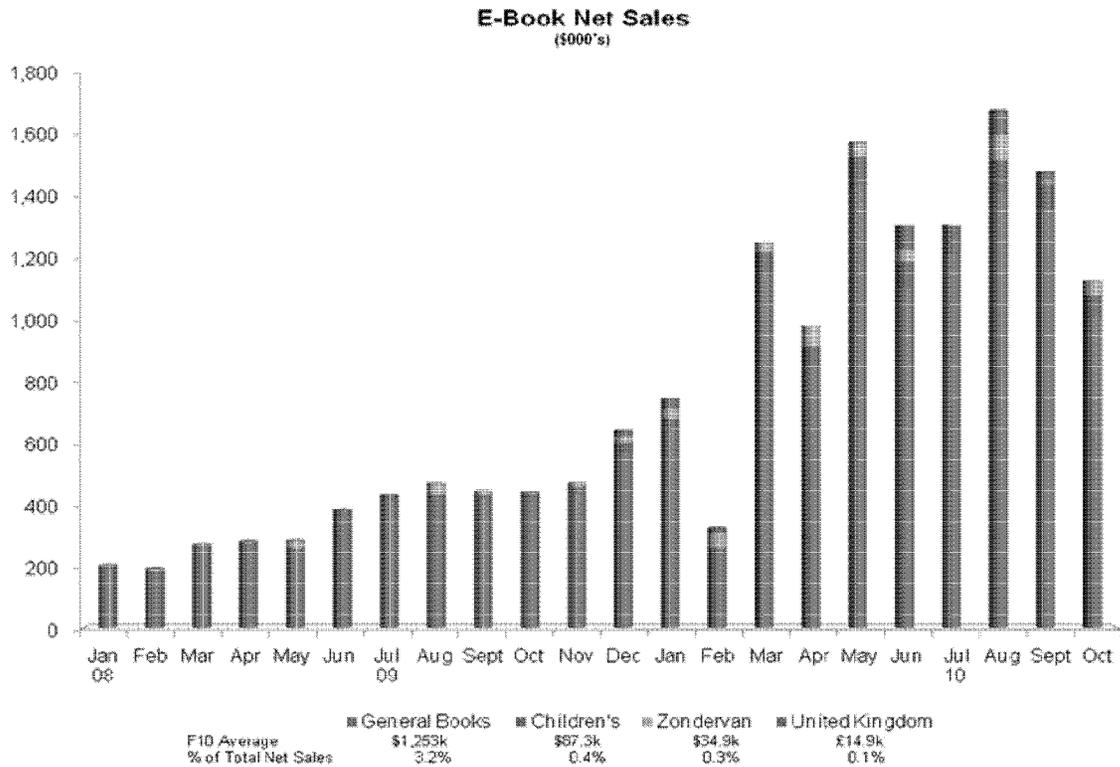
In the US, Amazon's results were very strong in the recent quarter. B&N and Borders just released third quarter results with same store sales declines of 3.2% and 12.1%, respectively. B&N was pounded by Wall Street despite a successful launch of the Nook. Analysts' primary concern is the loss of margin as the business shifts from store-based hardcovers sold at \$15 to loss generating ebooks at \$9.99. Borders announced that they are closing 200 mall stores, leaving only 130. B&N is closing 50 B. Dalton stores. In our meeting in NY two weeks ago, Borders CEO made strong warnings that continued pricing at \$9.99 of print and digital will destroy their business. A/R from Borders stands at \$55 million, with recent payments in the \$15 million range and expected cash in the next week of \$18 million. Costco and Walmart are also struggling to figure out how to respond to the faster than expected shift to digital content. In the UK, High Street retailers continue to struggle and there are concerns of Borders (separate management than US) going under. We currently have exposure of £.7 million.

### **Digital**

Consumer pricing, timing and format are at the heart of the ebook problem however we only control timing and format. We are developing a windowing strategy for ebooks to address these issues. The plan under consideration is to create a new digital format with a higher price and to begin delaying some of our low priced ebooks. Specifically for the first half of 2010 the plan is the following:

- Delay by at least one month, the \$9.99 "epub" ebooks of our top 5 books beginning in the month of January in order to protect our bricks and mortar retailers and the hardcover sales window. Our major retailers, with the exception of Amazon, will applaud this decision.
- However, we feel that we can't adopt a print only policy and preclude digital consumers from having access to a legal ebook when the hardcover book goes on sale.
- Our plan is to introduce a new enhanced ebook format (with video and social media features) on the Apple platform for \$20-\$25 when the hardcover goes on sale. The result is that the consumer price of the enhanced ebook will be greater than the price of the hardcover in major retailers. Our strong belief is that our retailer partners (except Amazon) will prefer this to the current practice because the discounted hardcover at \$15 will be less than the \$20-25 enhanced ebook. We intend to work with our retailers to allow them to be agents for these sales for a small commission.
- MacMillan announced that they are trying to reduce ebook royalty rates from 25% to 20%. We are comfortable paying a 25% of net royalty. Some agents and authors would like a 50% royalty.
- Barnes & Noble released their version of an ebook reader, The Nook, costing \$259 and matching Amazon's most recent price cut for its latest edition of the Kindle.

- Appointed Charlie Redmayne as Chief Digital Officer and Executive Vice President and will also sit on the company's executive committee. He will be responsible for overall digital strategy and will develop and manage its digital initiatives aimed at consumers.
- Another 7,500 older backlist titles have been identified as titles that would benefit from e-book conversion. This project began in November and will continue to the end of the fiscal year at a cost of \$2 million. Payback on this investment is expected within 2 years.
- Chart below represents the past 22 months of HarperCollins e-book sales by division.



**Other Highlights**

- Project Z - UK publishers approached HMV (parent company of Waterstones) and there is strong interest to join the proposed JV with publishers to form a company which will in turn compete with Amazon. It appears that RH is not willing to put up any money and is suggesting that a deal be structured where the publishers put up no money and get a small equity share.
- Hired Diane Bailey, New Human Resources SVP
- Significant new signings include Tim LeHaye, author of Left Behind series which sold 65 million copies (Zondervan) and a new poetry anthology by Shel Silverstein from materials owned by the estate of the late author.
- Three year plan / strategy outlooks are currently being worked on in all divisions with a targeted January completion.