

**HAIGHTS CROSS**

**November 11, 2003**  
**3:00 p.m. CST**

Moderator           Ladies and gentlemen, thank you for standing by, and welcome to the Hights Cross third-quarter financial conference call. At this time, all lines are in a listen-only mode. Later, we will conduct a question and answer session, giving instructions at that time. As a reminder, this conference is being recorded. I would now like to turn the conference over to Chief Executive Officer, Peter Quandt, and Chief Financial Officer, Paul Crecca. Please go ahead.

P. Quandt            Good afternoon. This is Peter Quandt speaking. Welcome to the Hights Cross third-quarter earnings release conference call. Paul Crecca, our CFO, will also be speaking in just a few minutes. Before Paul goes over the specific financials, I would like to spend just a few moments commenting on the current educational and library markets and the competitive conditions, and then review some of our business highlights.

The sluggish U.S. economy has resulted in a significant decline in state and local tax revenues, from which 93% of school budgets are derived and virtually all library budgets come from. Fiscal 2003 was reportedly the toughest year for state receipts since World War II, and more than half of the states have reported reduced funding on education for 2003.

In addition, federal funding from the No Child Left Behind Act has been slow to make its way to schools. As the new school fiscal year took effect this last summer, officials have been reporting very cautious spending in all areas, including new educational instruction materials and library collections.

The American Association of Publishers EIH's publishing report on industry revenue trends illustrates the current situation with depressed sales this summer, and year-to-date industry revenue through September up a modest 3.6%. The media investment bank, Veronis Suhler Stevenson, projects K-12 spending on instructional materials to be up just one percent this year and 1.5% next year. But we believe – and Veronis Suhler projections are consistent with this – that the compound annual growth rate will start picking up in 2005, and will yield a total compound annual growth rate of 3.5% for the 2002 to 2007 period.

For the library market there is no industry-tracking organization, but a *Library Journal* survey reported that 62% of public schools and school libraries had decreases in their 2003 budgets.

On a year-to-date basis, through September, our K-12 supplemental revenue, which consists of our Sundance/Newbridge units and our Triumph unit, is up 9% versus prior year, well ahead of the industry average of 3.6%. Growth is driven by the success of our Triumph Learning test prep line, which is closely tied to the No Child Left Behind themes of accountability and assessment, and our Sundance/Newbridge lines of guided readers and intervention programs. In addition, we are receiving excellent customer reviews on our new Reading PowerWorks program, which is now being released, and which is closely aligned to No Child Left Behind standards.

In the library sector, our Recorded Books unit growth has slowed, and our Chelsea House children's and young-adult unit has experienced declining revenue and profits, a direct result of the current budget situation. Libraries are buying fewer titles, primarily front-list titles, and delaying additions to existing collections.

To spur growth in these challenging times, Recorded Books has expanded its offerings to include new lines launched earlier this month, including the Modern Scholar audio college courses, large-print books, and the Film Movement DVDs. Recorded Books was also negatively impacted this year in the retail channel, where we did not have another blockbuster title to make up for the exceptionally strong sales last year of Tolkien's *Lord of the Rings Trilogy*. Rentals at our Travel Center locations were hurt by the depressed trucking industry and the loss of a major truck stop outlet.

Chelsea House has experienced attrition in its backlist, but has responded by publishing 190 new and distinctive titles for the autumn, and has another 235 new titles planned for next year. In addition, we are expanding our sales force at both companies to deepen penetration in selective high-opportunity geographies, and to capture additional share in a tight and competitive market.

In summary, while the current budget situation has slowed our growth in 2003 and will make for a challenging 2004, we expect the market to pick up thereafter and the long-term fundamentals for Haight's Cross to remain very

strong. Paul, our CFO, will now go through our detailed financial performance.

Paul.

P. Crecca

Thanks, Peter. Good afternoon, everyone. I'll be discussing Hights Cross's financial results for the third quarter and nine months ended September 2003. My comments will focus on our continuing businesses unless otherwise noted.

For the third quarter 2003, Hights Cross reported revenue of \$42.2 million, which was essentially flat to last year's same period. Our Sundance/Newbridge business, our K-12 supplemental education publisher, achieved third-quarter revenue of \$13.7 million, which was up \$2.1 million or 18% from last year, reflecting a large single order for a quasi-adoption of the over 2000 science titles in the Sundance and Newbridge catalog.

Triumph Learning, our state-specific test prep business, reported revenue of \$6.5 million for Q3 2002, representing 10% growth as compared to last year.

Recorded Books, our publisher of unabridged audio books, realized revenue for the third quarter of \$15.2 million, which was down \$2 million or approximately 12% from last year. Recorded Books' performance reflects a

\$2 million decline in the retail channel, the softness of which Peter noted earlier, which is affected by soft economic conditions as well as a very strong performance in 2002 for the *Lord of the Rings Trilogy*.

Our Audio Adventures imprint, which, as Peter mentioned, is distributed through highway Travel Centers, realized a \$700,000 revenue decline in the third quarter. In addition to being affected by soft economic conditions, this performance was also impacted by the loss, in January 2003, of one of our significant distributors, representing about 200 of the retail outlets of the approximate 670 outlets in the Audio Adventures network. We've replaced those outlets with 165 new and different outlets, and they've been gearing up and will be in full operation by the end of the year.

These soft retail channels for Recorded Books were partially offset by 7% growth in Recorded Books' core library channel, which remains relatively strong in the soft economy.

Q3 2003 revenue for Oakstone of \$3.9 million and Chelsea House of \$2.9 million were each off approximately 8% to the same period in 2002.

Net income for the third quarter 2003 was a net loss of \$8.6 million, as compared to net income of \$5.3 million for Q3 2002. The most significant items in this net income performance were the non-operating charges related to our August 20<sup>th</sup> debt recapitalization, including the \$9.2 million redemption premium on our previously outstanding subordinated note, and a \$3.2 million write-off of deferred financing costs related to prior financings. Cost of goods sold, SG&A, and amortization of prepublication costs for the quarter each increased slightly.

Third-quarter 2003 EBITDA of \$12.2 million was down \$1.4 million, as compared to the \$13.6 million the same period 2002. On flat revenue for Q3 2003, this EBITDA reflects start-up expenses in 2003 related to the consolidation in Massachusetts of our warehouse and customer service functions for our Sundance/Newbridge, Triumph Learning, and Chelsea House businesses.

Also in 2003, we've absorbed certain overhead costs, after certain reductions had been taken, relating to our Oakstone Legal and Triumph Software businesses, which we have exited. Further, 2002 EBITDA reflects the benefit

of certain bad-debt and inventory obsolescence reversals, resulting from a consistent application of accounting policies in a strong business environment.

Turning to our nine-month financial performance, for the nine months ended September 30, 2003, Hights Cross revenue of \$124.6 million was just slightly below the prior year of \$125.4 million. For the nine-month period, Sundance/Newbridge reported 6% revenue growth to \$37.8 million, including the large quasi-adoption order I mentioned earlier.

Triumph Learning achieved revenue growth of nearly 16% for the nine-month period, to \$18.4 million, resulting from strong performances in test prep products in Pennsylvania, North Carolina, Texas, Florida and Tennessee.

Recorded Books' nine-month 2003 revenue was down \$2.6 million, or about 5%, to \$46.2 million. The retail channel for the nine months ended was off \$3.2 million due to the strong 2002 sales of our *Lord of the Rings Trilogy*, as well as soft economic conditions impacting the retail channel.

Our Audio Adventures Travel Center channel was off \$1.9 million, reflecting the loss of the large distributor I mentioned earlier and, also, the slow economy.

Recorded Books' core library channel was up 7% for the nine-month period, reflecting the continued strength of its new title publishing plan.

Oakstone Publishing revenue for the nine months ended 2003, of \$12.1 million, was down 10%, due primarily to the strong 2002 MKSAP sales. MKSAP is our tri-annual Medical Knowledge Self-Assessment Program on audiocassette, and is Oakstone's largest product line. It is a tri-annual program, so strong 2002 impact there, no counterpart in 2003.

Chelsea House revenue of \$10.1 million for the period was down 12%, reflecting their backlist, our soft backlist performance, which continues to be soft in a weak library market, as Peter mentioned.

For the nine months, a net loss of \$2.8 million in 2003 compared with a net loss of \$31.7 million for the comparable period of 2002. The 2002 net income performance reflects a non-operating charge of \$48.6 million for the valuation of goodwill pursuant to new accounting rules in 2002. This was partially offset by the non-operating charge in Q3 2003 of totaling \$12.4 million related to our August 20<sup>th</sup> debt recapitalization.

The nine-month September 2003 net income also reflects \$2.9 million of restructuring and other one-time costs related to the consolidation of our warehouse and customer service operations I mentioned earlier, while the nine-month 2002 net income includes a \$2.1 million provision for the 2002 equity plan. Both of these items are also reflected in the nine-month EBITDA performance for the respective periods, which I'll be discussing shortly.

For the nine-month period, gross margin was down slightly, reflecting our revenue performance. SG&A expenses increased modestly for the period, reflecting investments in marketing programs across the business, and amortization of prepublication costs increased \$1.1 million for the nine months ended September 2003.

Turning to EBITDA for the nine months, EBITDA for the nine months ended September 2003 of \$34.1 million, which includes the \$2.9 million charge I noted a moment ago, was down \$3.9 million, as compared to the \$38 million of EBITDA for the same period of 2002, which reflects the \$2.1 million charge related to the 2002 equity plan I mentioned a minute ago. EBITDA for the period further reflects the benefit, in 2002, related to 2001 subscription-based

shipments at Recorded Books, which slipped into early 2002, for which there is no counterpart in 2003.

2003 EBITDA reflects overhead absorbed in 2003, net of certain reductions, which was previously shared by our Oakstone Legal and Triumph Software businesses, which we have exited. 2002 EBITDA also includes the benefit of certain bad-debt inventory obsolescence in sales return reversals, as I mentioned earlier.

For the nine months ended September 2003, we have made investments in the business of approximately \$12.4 million, the majority being development costs for new products.

That concludes our formal comments on our Q3 and nine-month year-to-date performance. We'll now open it up for questions.

Moderator

We have a question from the line of Steve Weiss, Bear Stearns. Please go ahead.

S. Weiss Peter and Paul, I have a couple questions. First, I was wondering if you could maybe give us some sense of visibility currently into the fourth quarter? Any thoughts that you can provide there would be helpful.

P. Crecca We see the fourth quarter, really, and our full-year performance, being quite consistent with our nine-month year-to-date performance, absent other changes in the market. It's been a fairly consistent trend that we've seen and, once again, expect the full-year and fourth quarter to reflect our nine-month, very similar to our nine-month year-to-date performance as compared to the prior year.

S. Weiss Meaning that it's possible that EBITDA might be down by like a million dollars again?

P. Crecca That is a possibility, yes.

S. Weiss Just so I understand the cost side of things, the \$2.9 million charge related to all of the consolidation activities you mentioned, is that inclusive of some of the sales and marketing investments you cited as well?

P. Crecca                    No. Those are purely costs associated with the consolidation of warehousing, customer service and IT functions at our Massachusetts facility. The marketing and sales programs are pure operating expenses.

S. Weiss                    Can you give us a sense of those incremental costs?

P. Crecca                    We have been, for the last several years, transitioning to much more of an internal sales force from independent reps. We continue to bring on internal employee-based sales reps, and that has a cost associated with it. I guess I'd quantify that; in the third quarter, it's somewhere in the range of probably \$300,000 to \$500,000.

S. Weiss                    When do you think that fully anniversaries through your numbers?

P. Crecca                    That, I'd have to take a look at, honestly, Steve.

S. Weiss                    Okay. Can you remind us, on the consolidation, what that's ultimately going to save you guys?

P. Crecca                   The largest impact from the consolidation will be efficiency. What we have done is we have consolidated the warehousing and customer service functions of three businesses. In the process of doing so, we have taken on additional space, more space than we had previously, and in doing so we have moved into a new and modern facility, which is going to provide us with, again, a lot of efficiency and certainly better customer service.

The leases that we exited, frankly, were lower-cost leases than the lease that we have today. So on an absolute basis, we'll probably not see great savings in the financial statements, but we will see operating efficiencies across the three or four businesses that have been consolidated under that facility.

S. Weiss                   Great. Lastly, are you seeing anything notable in terms of either the competitive environment, anything worth noting there in the current environment that you're operating in? Then, also, with respect to acquisitions, if you could give us a sense of what the M&A market might look like.

P. Quandt                I don't think there's anything new in the competitive environment. I think that our product lines, our businesses, are very strong. I would say the one area that we're probably seeing more competition than we did six months ago is in

Newbridge with lines of leveled readers. But in general, there's about the same level of competition and we're faring very well.

As far as acquisitions, we are looking at a number of different acquisitions that would be fold-ins with existing businesses, things that are very close to our existing businesses. But it's very, very early in this stage of development, and we don't have anything that's at all concrete at this point.

S. Weiss Fair enough. Thanks, guys.

Moderator We have a question from Ryan Watson, Stanfield Capital. Please go ahead.

R. Watson Yes, just going through your financials I noticed your interest expense for the nine months was a little higher than I would have forecast. How should we think about interest expense on a yearly basis, going forward? Your capital structure is pretty simplistic, so I'm trying to figure out where I'm going wrong here. Should I include the preferreds in there?

P. Crecca                   No. I think we could break it down for you separately, but it does include the 14% PIK interest through its redemption of August 20<sup>th</sup> on our sub-note. So that, perhaps, is the component that may have been missed.

R. Watson                   So basically, though, going forward it's the unsecured coupon and the bank loan, and that really is where the interest is coming from?

P. Crecca                   The coupon on the secured floating-rate term loan and on the senior note, correct.

R. Watson                   Okay. What was cap ex for the quarter or for the nine months?

P. Crecca                   Cap ex for the quarter was approximately \$3.7 million, and that includes both product development of approximately \$3.2 million, the balance being traditional furniture and equipment.

R. Watson                   Do you have guidance for the year on what you expect to spend?

P. Crecca                   It would be pretty much the same on a quarterly basis. It would be consistent with what we have spent nine months. You can annualize the nine months and that would be a good outlook for the full year.

R. Watson                   So the nine months, then, is what, maybe like (parties speaking simultaneously)... routine?

P. Crecca                   It's not at all seasonal. It's pretty ratable.

R. Watson                   The consolidation of the IT functions – I think it's amongst three business groups – you said you might see some operating efficiencies there. I think what Steve was trying to get to, would that fall through to the EBITDA lines where we'd see some sort of margin improvement, because you guys are keeping revenues rather flat, but profitability keeps declining marginally, but still declining. Is there some sort of way you're working besides this to stem that margin erosion, or is this the way you expect to –?

P. Crecca                   Let me address the warehouse question so that there is some clarity on that point. The three warehouse facilities – actually more than that; there are five warehouses that we exited – were each under lease agreements that honestly

had slightly lower per-square-foot lease costs than the new modern facility that we're in. The facilities that we were in were not nearly as modern and up-to-date and efficient as the facility that we're in today.

In addition, in the new facility, we've taken on approximately 25% extra space. So on an all-up basis, we'll not actually see dollar-benefited EBITDA by virtue of the somewhat higher per-square-foot lease cost and the extra space. We clearly have saved - we have saved headcount in the consolidation, but that's been offset by the cost of the more modern and increased size of the facility.

We will be taking, and we continue to look on a regular basis at our operating margins, and do everything that is consistent with our long-term growth objectives for the business - again, not doing something foolish that would hurt the underlying value of these assets, but we continue to look at margin improvement across each period, each month, each quarter, and certainly when we look at a full-year plan.

R. Watson

Okay. Was there something this quarter, or that you've seen this year, that hasn't worked as well, in terms of kind of rationalizing costs or building up margin, because your margins have gone down slightly?

P. Crecca                   As I mentioned, there are certain non-recurring type items that I think you have to break down; back those out and look at margin in that light. But no, we have not experienced any operating issues with operating costs that would drive the margin down. They've been largely impacted by special items.

R. Watson                   Then, just as a side point, is it possible to, maybe in future press releases, to get a little bit more operating information, or do you intend to just put that out with your Q?

P. Crecca                   What are you thinking of?

R. Watson                   Just a little bit, maybe, more of a breakout of the cash flow statement and a little bit more about the balance sheet. I guess the balance sheet is pretty simple, so maybe not that, but just at least the cash flow statement and maybe a bigger income statement as well.

P. Crecca                   Our 10-Q, which will be out in a day or so, will probably contain all the details that you'll need.

R. Watson                    Okay, great. Thank you.

Moderator                   We have a question from Todd Morgan, CIBC World Markets. Please go ahead.

T. Morgan                    This is a little bit of an apples-and-oranges comparison, but they're both the businesses in the library segment. I was hoping you could to that a little bit. Seven percent growth in the core library segment of the Recorded Books business versus some continued erosion at Chelsea in the quarter - can you talk about, compare and contrast, what's going on there?

P. Quandt                    A couple of differences in the businesses: Chelsea is largely going to school libraries. Recorded Books is largely going to public libraries. In addition to that, Chelsea is a good franchise. Recorded Books is a great franchise. So it's different markets and different strengths of the business.

T. Morgan                    But on the Recorded Books side, I would imagine a lot of that is part of the various contracts you have with some of the libraries. Is that part of the growth that you're seeing there?

P. Quandt                   It's in both COPs and then just one-shot orders from libraries, yes.

T. Morgan                   Triumph Learning: Help me understand, a little bit, the long-term competitive positioning there. Obviously, you're showing pretty good numbers right now and it's a pretty strong business. Going forward, especially in the No Child Left Behind area, and you talked a little bit about that, I think you see a lot of the large testing companies basically signing contracts with the states to go and develop statewide testing standards and tests. Why wouldn't they simply continue on and get into the test preparation side, and try and create sort of the one-stop package for the states to look from, and how does Triumph compete in that kind of environment, if that's what's going to happen?

P. Quandt                   A couple of thoughts: I'm not sure, at all, that they're going to want to do that. I think they have a pretty strong conflict of interest. If they're going to be the test creator; then they're going to give you information on how to improve your test scores; I think that's a conflict. We haven't seen them do that in the past. Most of the competition that we receive today is actually from privately held small companies.

There are a couple of good competitors too, I've seen, as well as a lot of companies that aren't such good competition. But I think just the fact that we have been the number-one company in most of the states that we're in, and once you're in and you get the schools used to using your product, it's pretty hard to displace a successful product line. People don't like to switch once they're used to using a product line.

T. Morgan                      Lastly, again, in the Recorded Books segment, you talked about the retail channel being weak. Can you give me some sense of how much of that might have been tied to last year's best sellers versus this general weakness? Is it half of that?

P. Quandt                      I'll ask Paul to comment on that.

P. Crecca                      In the quarter, *Lord of the Rings* was a very special title. We typically do not have blockbuster titles like that, and I would note that we acquired the rights for *Lord of the Rings* long before there was announcement of a movie deal. So we certainly didn't pay up in terms of royalty for the rights to it.

With that said, it was a very strong hit in 2002, the year following the release of the first motion picture. In the third quarter, 2002, *Lord of the Rings* represents about \$1.6 million of revenue, whereas in the third quarter of 2003 it's just \$300,000. So, as you can see, of the revenue decline for the retail channel of \$2.2 million, more than half of it relates to *Lord of the Rings*, and I would say – I don't have the nine-month data available – but the nine-month impact of *Lord of the Rings* would probably be even more significant than the third quarter. Much more than 50%, probably 75%, I'm guessing, could be attributable to *Lord of the Rings*.

T. Morgan                      That's helpful. Thank you very much.

P. Quandt                      We'd like to thank you then. Thank you for attending.

P. Crecca                      Thank you.

Moderator                      Ladies and gentlemen, this conference will be available for replay after 6:00 a.m. November 11<sup>th</sup> through midnight November 25<sup>th</sup>. You may access the AT&T Teleconference Replay System at any time by dialing 1-800-475-6701

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That does conclude our conference for today. Thank you for your participation and for using AT&T Executive Teleconference. You may now disconnect.