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Reed Elsevier: Bringing Down the House - Why Elsevier is Vulnerable in its Upcoming Big Deal Negotiations

Ticker	Rating	CUR	28 Mar 2011 Closing Price	Target Price	TTM Rel. Perf.	EPS 2010A	EPS 2011E	EPS 2012E	P/E 2010A	P/E 2011E	P/E 2012E	Yield
REL.LN	U	GBp	520.50	450.00	-1.9%	43.40	45.20	47.90	12.0	11.5	10.9	4.4%
REN.NA	U	EUR	8.86	8.00	-1.9%	0.78	0.82	0.87	11.4	10.8	10.2	4.7%
MSDLE15			1184.28			94.42	108.33	121.88	12.5	10.9	9.7	4.2%

O – Outperform, M – Market-Perform, U – Underperform, N – Not Rated

Highlights

- **Elsevier will be very vulnerable to demands for discounting the price of its Big Deal contracts as it faces a fresh round of negotiations in the months to come.** The combination of weak financial conditions (which make academic libraries' threats to discontinue Big Deals more credible), and Reed Elsevier's need to avoid negative headlines, after a string of lacklustre results and cautious guidance has left investors with cause for concern, suggest that academic and research libraries will have an unprecedented opportunity in 2011 to win substantial discounts from Elsevier. While there is virtually no visibility on the schedule of negotiations, the one with Research Libraries UK has the potential of proving highly damaging to Elsevier, as a public break would probably lead investors to conclude that problems in the journal business are deeper than consensus would suggest.

- **Ultimately, we suspect the industry structure for the dissemination of science may have to be rethought.** The invitation to a publishers-only workshop that will be held in London this week reads "Can we learn not just to live with open access, but to love it as well? Has the time come to turn the threat into an opportunity?" While it may be too early to declare that alternative economic models will prevail, it is at least worth considering the possibility that subscription and Open Access will live side by side going forward.

- **The financial impact on Reed Elsevier of widespread discounting for Elsevier Big Deals would be material, but much lower than facing deeper cuts from universities renouncing Big Deals altogether.** Our base case scenario for Elsevier's journal business is 2% organic decline in the coming years, derived by factoring in both the proportion of universities in the US, UK and the most challenged Western European countries that we expect will seek cuts and the level of cuts they will apply. Compared with the historic 5-6% organic growth for Elsevier as a whole our base case of 1-2% organic growth (we think non-journal revenues will partially counteract the journal decline) clearly represents a material financial impact. However, if Big Deals are renounced on a wide scale, the impact will be far more material, and we believe the probability of a wave of discontinued Big Deals cannot be ruled out any longer. We have quantified the impact on Reed Elsevier of a 25% reduction in Science and Technology journal spending and a 15% reduction in Health Science journal spending, phased between 2012 and 2015. This decline in revenues would lead to an 8 to 14% reduction in Reed Elsevier's 2015 EPS (from 54.1p to 46.3-49.2p), depending on how aggressively Elsevier would pursue cost reduction.

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Investment Conclusion

The key historical driver to Reed Elsevier's performance has been LexisNexis, the legal and risk management division, which in recent years contributed over 40% of operating profit growth. Investors have been increasingly concerned since the beginning of 2009 about the performance of the core US legal research business and of some print businesses within LexisNexis as a result of the poor economy; in addition, 2010 results confirmed that growth of Elsevier (the STM publishing division) had slowed because of pressure on academic budgets. In addition to the cyclical issues outlined earlier, we are increasingly concerned about longer term structural issues in US legal research and about a prolonged decline in funding for academic libraries which could trigger lower spending on STM journals. Our analysis suggests that a progressive break-up of the company could yield a 20 to 30% increase to the value of the company, but that management is unlikely to pursue more than minor adjustments to the portfolio (such as continuing the divestiture of RBI's assets and selling the Exhibitions business) in the next year or two. We rate Reed Elsevier Underperform with target prices of £4.50/€8.00 respectively for the UK and the Dutch stock.

Details

Elsevier will be very vulnerable to demands for discounting the price of its Big Deal contracts as it faces a fresh round of negotiations in the months to come.

The combination of weak financial conditions (which make academic libraries' threats to discontinue Big Deals more credible), and Reed Elsevier's need to avoid negative headlines, after a string of lacklustre results and cautious guidance has left investors with cause for concern, suggest that academic and research libraries will have an unprecedented opportunity in 2011 to win substantial discounts from Elsevier. While there is virtually no visibility on the schedule of negotiations, the one with Research Libraries UK has the potential of proving highly damaging to Elsevier, as a public break would probably lead investors to conclude that problems in the journal business are deeper than consensus would suggest.

Sell side consensus expectations for revenue growth at Elsevier suggest that the financial community anticipates a progressive return of revenue increases in line with those of the past (**Exhibit 1**). We think these forecasts are overly optimistic, and ignore the reality of increasingly challenging budgets for academic libraries; our forecast is for much slower growth, at 2% or less in 2012 and 2013, with journal revenues declining by about 2% (**Exhibit 2**).

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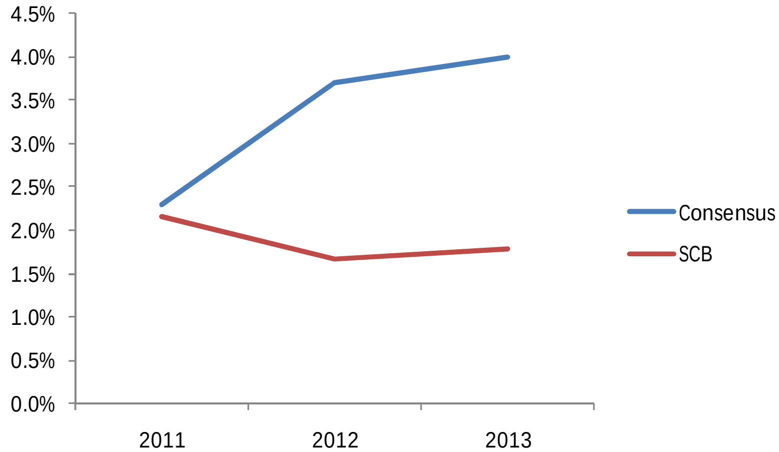
Exhibit 1

Consensus forecasts suggest that Elsevier will return, by 2012-13, to organic growth in the 4% range, while we expect growth below 2%



Source: Interviews, Bernstein estimates and analysis

Exhibit 2

We forecast Elsevier organic growth to decline to less than 2% after 2011

£ million	2010	2011E	2012E	2013E	2014E	2015E
Elsevier Science and Technology	1,015	1,018	1,014	1,011	1,009	1,008
Journals as % of S&T	78%					
Elsevier S&T growth rate		0.3%	-0.4%	-0.3%	-0.2%	-0.1%
of which Journals	792	784	768	753	738	723
Journals growth rate (%)		*-1%*	*-2%*	*-2%*	*-2%*	*-2%*
of which Other	223	234	246	258	271	285
Other growth rate (%)		*5%*	*5%*	*5%*	*5%*	*5%*
Elsevier Health Sciences	1,011	1,051	1,090	1,130	1,173	1,219
Journals as % of Health Sciences	20%					
Elsevier Health growth rate		4.0%	3.7%	3.7%	3.8%	3.9%
of which Journals	202	202	198	194	190	187
Journals growth rate (%)		*0*	*-2%*	*-2%*	*-2%*	*-2%*
of which Other	809	849	892	936	983	1,032
Other growth rate (%)		*5%*	*5%*	*5%*	*5%*	*5%*
Elsevier	2,026	2,070	2,104	2,142	2,183	2,227
Elsevier growth rate (%)		*2.2%*	*1.7%*	*1.8%*	*1.9%*	*2.0%*

Source: Interviews, Bernstein estimates and analysis

Note: 2011E-2015E numbers are on a constant currency basis from 2010

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Elsevier's academic journals are now being sold primarily through Big Deals (the company indicates than less than 10% of journal revenues derive from individual subscriptions)[1]. These contracts last between three and five years, leading to a steady stream of renewal negotiations every year. We now think that academic libraries which are going to negotiate the renewal of their Big Deals face an unprecedented opportunity to win major price concessions from Elsevier, in order to stave off the even larger revenue cuts (and the potential negative publicity) that would derive from abandoning Big Deals and reverting to individual subscriptions.

One such negotiation will see Elsevier facing Research Libraries UK. The universities belonging to this membership group are, effectively, the core market for Elsevier in the UK (**Exhibit 3**). These universities are heading into a joint negotiation knowing that their funding – in the next years – will be under severe pressure as a result of the UK government budget cuts. The negotiations will be led by Deborah Shorley, the Director of Library Services at Imperial College. In an article published on the Felix (the Imperial College student newspaper)[2], Ms. Shorley indicated the negotiating position of Research Libraries UK. The group is asking three things: a 15 % reduction in the base price of the Big Deal (instead of a 5% increase), an end to up-front payments and a switch to invoicing in UK pounds (currently it is done in Euros, leaving the foreign exchange risk to the libraries).

[1] For a detailed description of Big Deal contracts, please see our call Reed Elsevier: The Inevitable Crunch Point - Downgrading to Underperform Because of Growing Concerns on Elsevier

[2] http://www.felixonline.co.uk/?article=808

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Exhibit 3
Members of Research Libraries UK

University of Aberdeen Library and Historic Collections
University of Birmingham Information Services
University of Bristol Information Services
British Library
Cambridge University Library
Cardiff University Information Services
Durham University Library
Edinburgh University Library
Glasgow University Library
Imperial College London Library
John Rylands University Library, University of Manchester
King's College London Information Services & Systems
Leeds University Library
University of Liverpool Library
University of London Research Library Services
Library of The London School of Economics and Political Science (LSE)
National Library of Scotland
National Library of Wales
Newcastle University Library
University of Nottingham Information Services
University of Oxford Libraries
School of Oriental and African Studies (SOAS)
The University of Sheffield Library
University of Southampton Libraries
Trinity College Library Dublin
UCL Library Services
V&A Museum
University of Warwick Library
Wellcome Library

Source: RLUK

In normal times, it is unclear that Research Libraries UK would have even demanded a price reduction. After all, conventional wisdom suggests that libraries will want to provide all the available journals to its core users, and this means that the negotiating position of RLUK would be very weak. Recent experiences from other universities which have abandoned their Big Deals, however, suggest that cutting a significant number of titles is a possibility. In our downgrade call (**Reed Elsevier: The Inevitable Crunch Point - Downgrading to Underperform Because of Growing Concerns on Elsevier**) we described the case of a highly prestigious university which discontinued, at the end of 2010, two of its Big Deals (including one with a leading publisher), losing 90% of the titles acquired from this publisher, reducing by 30% its spending and incurring virtually no complaints from its 5000 core users. We attribute this surprising outcome to the fact that 20 to 25% of journals seem to account for 70 to 90% of the access to articles for many universities (**Exhibit 4** and **Exhibit 5**). The mysterious university is not alone: in recent years, prestigious research universities like Harvard, Stanford and Caltech have abandoned completely or totally

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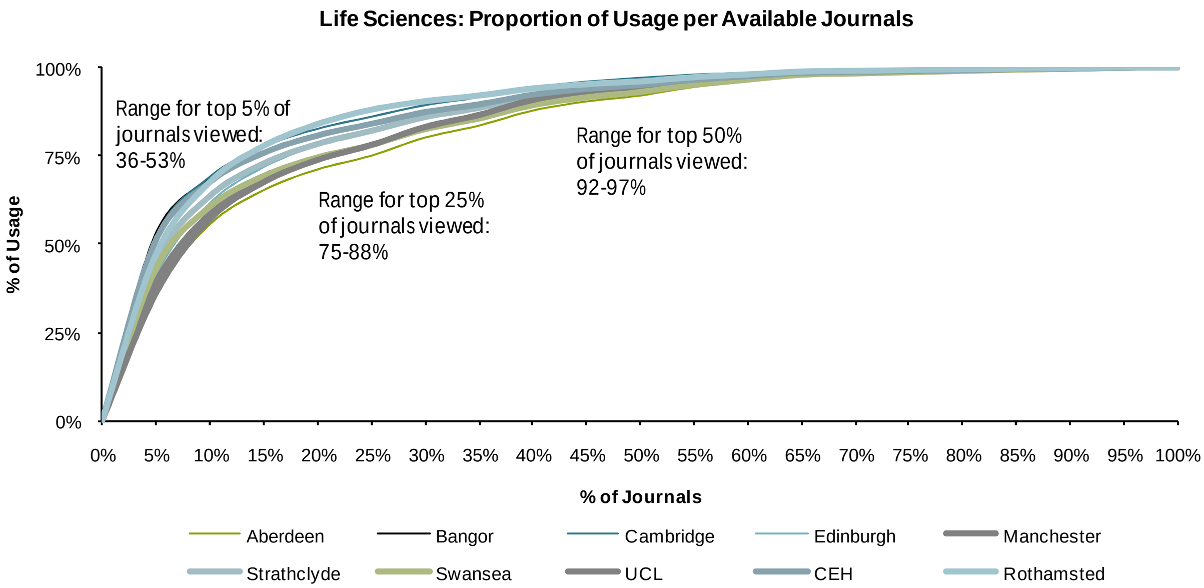
their Big Deals[3], driven by the same conclusion that readership of the "long tail" does not justify the price of the Big Deal. Some of them have moved to models in which the library pays the publisher per individual download at a reduced rate (very much as Ted Bergstrom suggests in the document referenced in footnote 3); the library, in turn, to encourage responsible behaviour, charges back to the faculty some of the costs of the download. We think that models like this, if negotiated properly, can lead to cost reduction in the region of 40 to 50%.

Exhibit 4

A low proportion of Life Science journals account for a high proportion of usage at a diverse range of universities in the UK…



Source: Research Information Network, Bernstein estimates and analysis

[3] http://works.bepress.com/cgi/viewcontent.cgi?article=1110&context=ted_bergstrom&sei-redir=1#search="caltech+elsevier+big+deal"

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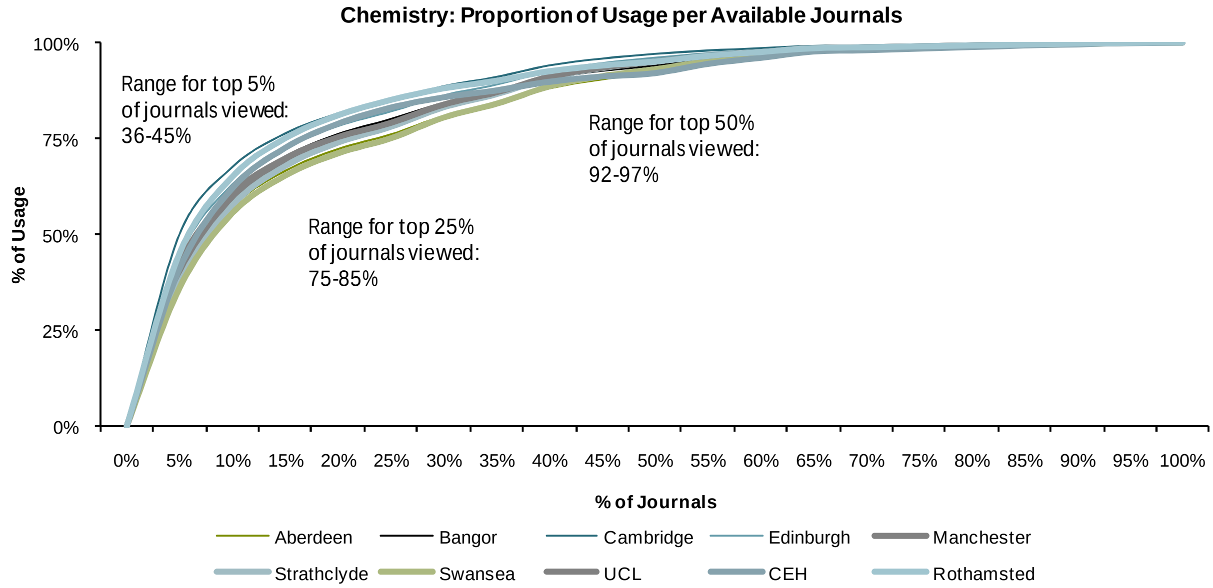
Exhibit 5

…it is a near identical story for Chemistry journals



Source: Research Information Network, Bernstein estimates and analysis

What makes the negotiating position of RLUK even stronger is the sense that – at this juncture in time – Reed Elsevier cannot afford the negative publicity that would derive from the RLUK announcing publicly that it is renouncing its Big Deals and is aiming to save 30% through targeted journal purchases. While the UK market may only represent 3 to 5% of the global journal market, the visibility of such a move would be both very significant in the eyes of other universities elsewhere, and it would lead investors to start wondering whether in fact the business is more vulnerable than consensus would suggest. Elsevier, therefore, is likely to be willing to agree to significant concessions, rather than risk the news of RLUK renouncing Big Deals affecting both its relationship with other universities and the way investors view the company.

Other universities which are heading into negotiations with Elsevier (as well as other publishers, but Elsevier is particularly vulnerable because of its public listing and the risk that investors will be scared by negative newsflow) may not have – individually – the same leverage. Nonetheless, to the extent that they can also threaten to feed the negative newsflow, 2011 could prove a year when the negotiating power shifts to university libraries everywhere – whether they will choose to exercise it or not, of course, depends on how concerned they are about the rising costs of the Big Deals on the one hand and about risking the loss of access to a substantial amount of journals on the other one.

Universities may find an additional element of help going into the next negotiations. Ted Bergstrom of University of California at Santa Barbara with two fellow economists (Paul Courant of the University of Michigan and Preston McAfee of Yahoo!) has been using the Freedom of Information Act to acquire copies of Big Deal contracts signed by various US Universities. Elsevier sued Washington State University to halt the release but lost the case[4] . In Texas, Elsevier and Springer raised objections with the State Attorney

[4] http://www.econ.ucsb.edu/~tedb/Journals/Order%20~%20Elsevier%20v.%20WSU.pdf

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General, but failed to stop the opening up of the contracts and the Attorney General sent a letter detailing its reasoning[5].

The authors plan to release as many contracts as possible to the public, giving universities a better sense of what terms and conditions have been attached to other contracts in the past. The ARL has, in turn, invited its members (the core market for Elsevier in North America) to refrain signing non disclosure agreements[6]. With more information available, it is likely that universities will be have much better negotiating power going forward.

Ultimately, we suspect the industry structure for the dissemination of science may have to be rethought – or "How I learned to love the Bomb"

One of the lingering concerns in the academic community is that a prolonged conflict between publishers and libraries could lead to a collapse of the academic dissemination model. We suspect that this would not be – ultimately – as dire as that. It may very well be that a mixed model will emerge, in which the top 10 or 15% of the journals will continue to be supported by subscriptions, both because they are widely read and because alternative funding models (like Open Access) would be prohibitively expensive. It remains to be seen whether the remaining 80% of the journals, which appear to fulfil a different need (provide a forum for authors to publish, rather than for researchers to read) could be funded through OA.

Publishers remain sceptical about the possibilities of Open Access, but – interestingly enough – a publishers-only meeting in London in these very days will be held to discuss the possibilities of OA. The invitation reads *"Can we learn not just to live with open access, but to love it as well? Has the time come to turn the threat into an opportunity?"* Lest we conclude that publishers have softened their views on OA, however, the invitation also suggests that publishers remain sceptical: *"Open access is here to stay, and has the support of our key partners. Funders see it as the way to maximise access and impact for the research they fund, policy makers are under pressure to make it happen. Publishers know it is much more complicated and threatening to make it work than is apparent to the advocates and the fund holders. But we would benefit from having a compelling, coherent and above all positive story to tell about the role we can play in achieving these objectives"*. Coming from a Reed Elsevier executive, this statement should lead everyone to wonder whether the company is starting to feel pressured by its customers and by the funders of research.

The financial impact on Reed Elsevier of widespread discounting for Elsevier Big Deals would be material, but much better than facing deeper cuts from universities renouncing Big Deals altogether

Our base case scenario for Elsevier's journal business is 2% organic decline in the coming years, derived by factoring in both the proportion of universities in the US, UK and the most challenged Western European countries that we expect will seek cuts and the level of cuts they will apply. Compared to the historic 5-6% organic growth for Elsevier as a whole our base case of 1-2% organic growth (we think non-journal revenues will partially counteract the journal decline) clearly represents a material financial impact. However, if Big Deals are renounced on a wide scale, the impact will be far more material, and we believe the probability of a wave of discontinued Big Deals cannot be ruled out any longer. We have quantified the impact on Reed Elsevier of a 25% reduction in Science and Technology journal spending and a 15% reduction in Health Science journal spending, phased between 2012 and 2015. This decline in revenues would lead to an 8 to 14% reduction in Reed Elsevier's 2015 EPS (from 54.1p to 46.3-49.2p), depending on how aggressively Elsevier would pursue cost reduction (**Exhibit 6**).

[5] http://www.econ.ucsb.edu/~tedb/Journals/TexasAttorneyGeneralRuling.pdf
[6] http://www.arl.org/news/pr/nondisclosure-5june09.shtml

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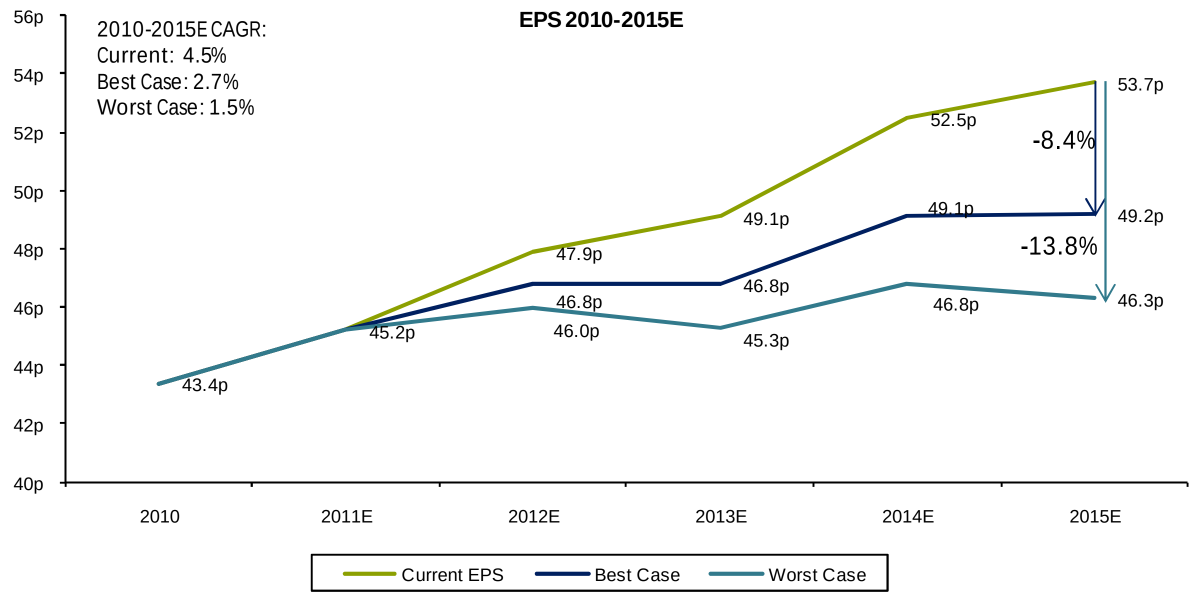
Exhibit 6

EPS could decline by 8 to 14% relative to our current forecasts



Source: Company reports, Bernstein estimates and analysis

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Disclosure Appendix

Valuation Methodology

For Reed Elsevier, we base our target prices on a price to earnings methodology. In order to calculate our target prices, we look at the current relative multiple (company price to earnings ratio (P/E) relative to MSCI Europe P/E) and then apply a target relative multiple given Reed Elsevier's future EPS growth prospects to 2013. We believe that the period between 2010 and 2013 represents a valid timeframe to assess the EPS growth prospects (**Exhibit 7**).

Exhibit 7
Valuation Methodology

Company	Rating	Currency	Market Cap	28-Mar-11 Price	EPS CAGR 2010-13E	2011E EPS	2011E P/E	Relative P/E Multiple	Target Relative P/E Multiple	Target Price	% Upside Downside
Reed Elsevier PLC	U	GBP	£6,230	520.5p	4.2%	45.2p	11.5x	105%	90%	450p	-14%
Reed Elsevier NV	U	EUR	€ 6,477	€ 8.86	4.5%	€ 0.82	10.8x	98%	90%	€ 8.00	-10%
MSCI Europe					**10-12%**		**11.0x**				

Source: Bloomberg, Company reports, Bernstein estimates and analysis

Risks

The key risk to our thesis and 12 month target prices for Reed Elsevier derives primarily from the impact of the economic cycle. While most of the revenues should be relatively stable irrespective of changes in economic activity, some segments (and in particular business to business advertising and exhibitions) are more sensitive than others, as none of them is fully insulated from a deep and lasting slow down of economic activity and, conversely, a faster than expected improvement of the economic cycle could drive an acceleration of earnings growth.

While market shares are relatively stable, fluctuations deriving from failure to win individual contracts or clients can negatively or positively affect the revenues of some divisions for a few years, since many contracts are typically multi-year and switching costs are high.

In addition to the risks mentioned above, Reed Elsevier is highly exposed to currency fluctuations: approximately 55% of its revenue is denominated in US dollars. A 1% change in the US Dollar causes around a 0.6% change in EPS. Our forecasts currently assume a £1:$1.60 average for the period between 2010 and 2012. Any major devaluation of the sterling and/or the Euro relative to the US dollar would have a direct positive effect both on EPS and on the value of assets located in the United States.

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  Outperform: Stock will outpace the market index by more than 15 pp in the year ahead.

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  Underperform: Stock will trail the performance of the market index by more than 15 pp in the year ahead.

  Not Rated: The stock Rating, Target Price and estimates (if any) have been suspended temporarily.
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- An affiliate of Bernstein received compensation for non-investment banking-securities related services from the following companies REL.LN / Reed Elsevier PLC, REN.NA / Reed Elsevier NV.

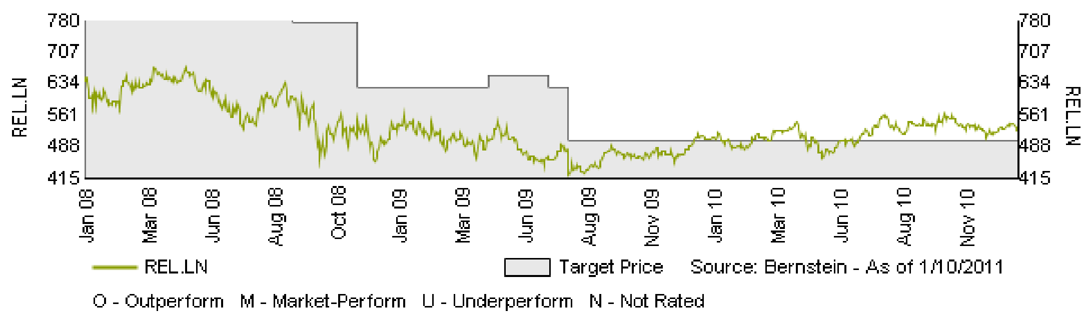
12-Month Rating History as of 03/28/2011

Ticker	Rating Changes		
REL.LN	U (RC) 03/10/11	M (RC) 05/07/10	O (IC) 12/04/07
REN.NA	U (RC) 03/10/11	M (RC) 05/07/10	O (IC) 12/04/07

Rating Guide: O - Outperform, M - Market-Perform, U - Underperform, N - Not Rated
Rating Actions: IC - Initiated Coverage, DC - Dropped Coverage, RC - Rating Change

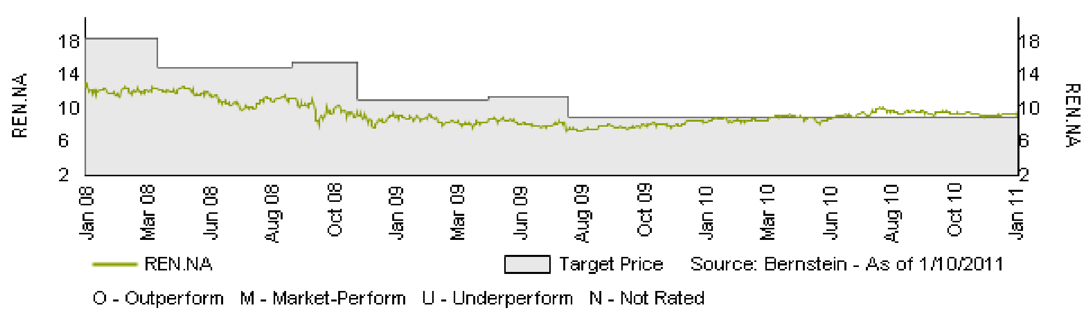
REL.LN / Reed Elsevier PLC

Date	Rating	Target(GBp)
12/14/07	O	866.35
09/11/08	O	775.00
11/25/08	O	625.00
04/29/09	O	650.00
07/08/09	O	625.00
07/31/09	O	500.00
05/07/10	M	500.00



REN.NA / Reed Elsevier NV

Date	Rating	Target(EUR)
12/14/07	O	18.48
04/04/08	O	15.00
09/11/08	O	15.50
11/25/08	O	11.00
04/29/09	O	11.50
07/31/09	O	9.00
05/07/10	M	9.00



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