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Reed Elsevier: The Inevitable Crunch Point - Downgrading to Underperform Because of Growing Concerns on Elsevier

Rating Change / Target Price Change / Estimate Change in Bold

Ticker		Rating	CUR	8 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	547.50	**450.00**	1.1%	43.40	**45.20**	**47.90**	12.6	12.1	11.4	4.1%
	OLD	M			500.00			45.20	48.30				
REN.NA		**U**	EUR	9.46	**8.00**	3.4%	0.78	**0.82**	**0.87**	12.1	11.5	10.9	4.4%
	OLD	M			9.00			0.83	0.88				
MSDLE15				1196.90			93.74	108.60	122.13	12.8	11.0	9.8	3.6%

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

Highlights

"We do not wish to cancel big deals, but we shall have no alternative unless the largest publishers substantially reduce their prices," Research Libraries U.K. Executive Director David Prosser

The Science & Technology business of Elsevier is likely to face another disappointing year in 2012, as academic institutions around the world are still faced with a difficult funding environment. While summary evidence of changes in the funding of academic libraries is still sketchy, anecdotal evidence suggests that academic and research libraries are still affected by further budget cuts in 2011. We think that, in aggregate, overall Elsevier revenues will rise 1-2% annually in the best of circumstances, well below the historic 5 to 6% growth rate and consensual 4 to 5%, for some years, and that the risk to our forecast is steadily shifting to the downside.

- **The "Big Deal" commercial model worked well for over a decade, but is becoming unsustainable in the current funding environment.** Librarians have been complaining for a long period of time that the "Big Deal" contract model (in which publishers granted academic libraries the electronic access to most or all their journals at a substantial discount to retail subscription rates) was constraining their resources to fund other areas of activity. Ultimately, however, academic libraries have continued renewing (and funding) "Big Deal" contracts: Elsevier claims that less than 10% of their revenues derive from individual subscriptions. We think this will become less tenable over time, as librarians are increasingly constrained by budgets which cannot keep pace with the spending increases called for by contracts. This means that librarians will increasingly scrutinize the portfolio of publications of each publisher and appraise the usefulness of each title on the basis of factors like usage, which opens up the risk that librarians may decide they can "live" without the lower "value" publications.
- **Universities which have started to renounce their "Big Deals" seem able to cope, and this experience, coupled with budget pressures around the world, represents a significant threat to the "Big Deal" model.** We have spoken to a large university which discontinued two of its "Big Deals" and found that their savings are large (in the 30% region), and the rate of complaint from the users is minimal. While a number of "best practices" may be required to accomplish similar results, we think that academic and research libraries around the world will pay increasing attention to these experiences, potentially triggering a stampede of discontinued packages in the years to come.
- **The best case scenario for Elsevier is a repeat of 2010 for several years, with limited organic growth and periodic flare ups of conflict with individual libraries (or, in some case, countries);**

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widespread decisions to discontinue "Big Deals" could lead to revenue and earnings decline. Our base case for Elsevier now forecasts that annual organic growth will remain at 2% in 2011, then decline to below 2% between 2012 and 2015 (at the very least), while consensus expects an acceleration to 4% by 2013. We believe, however, that 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. According to our model, this decline in revenues would lead to an 8 to 14% reduction in Reed Elsevier's 2015 EPS (from 54.1p to 46.7-49.6p), depending on how aggressively Elsevier would pursue cost reduction.

- **Investors should start to ask management what is their plan B, since the assumption that the current commercial model will prove sustainable looks increasingly uncertain.** The structural issues that we have outlined in this call are likely to play out over time, rather than in one year (because the multi-year nature of the Big Deal contracts means that they will not be discontinued all at once), the valuation of Reed Elsevier is more challenging than many investors realize.
  - While consensus P/E for 2011 is only an 8.2% premium to the MSCI Europe, the stock looks more expensive on an EV/EBITDA basis (a 15.1% premium) because of the relatively high debt. This means that a string of disappointing results in the largest and most visible business of the company could disproportionately affect the equity valuation. In addition, our base case EPS for 2011 and 2012 (45.2p and 47.9p respectively), stands 1.7% and 5.3% below consensus. We also think that the rest of the portfolio, characterized by a structurally challenged legal research business (LexisNexis Legal & Professional, particularly in the US) and some modestly performing cyclical businesses (RBI and Exhibitions) is unlikely to offset the disappointments we expect from Elsevier. The LexisNexis Risk Solutions business looks poised to continue performing well, but it only represents 15.3% percent of revenues and 22.6% of profits, and is therefore too small to offset the problems affecting the rest of the portfolio.
  - In the absence of workable alternatives that protect revenues if Big Deals are discontinued *en masse*, we are downgrading Reed Elsevier to Underperform. Our target prices decline from 500p to 450p for the Plc and from €9.00 to €8.00 for the NV stock.

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.

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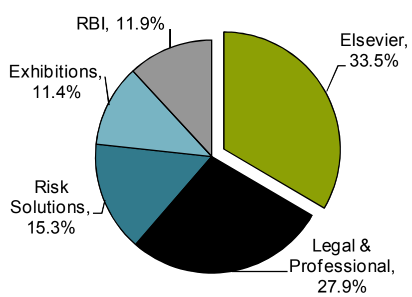
Details

The Science & Technology business of Elsevier is likely to face disappointing years beyond 2011, as academic institutions around the world are still faced with a difficult funding environment.

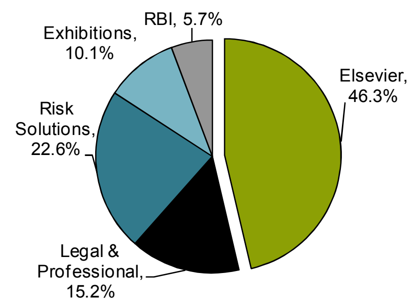
Elsevier is the largest division of Reed Elsevier, accounting for 33.5% of revenues and 46.3% of profits in 2010 (**Exhibit 1** and **Exhibit 2**).

Exhibit 1
Elsevier is the largest division of Reed Elsevier both in terms of revenues…



Source: Company reports

Exhibit 2
…and, even more so, profits



Source: Company reports

The management of Reed Elsevier indicated that the academic library environment will continue to be difficult in 2011, affecting the likely growth rate of Elsevier in 2011. While summary evidence of changes in the funding of academic libraries is still sketchy, anecdotal evidence suggests that academic and research libraries are still affected by further budget cuts. In North America, the ARL (the Association of Research Libraries is a non profit membership organization of 126 research libraries in North America – effectively the core market in North America for STM journals; for a full list of member libraries please follow this link: http://www.arl.org/arl/membership/members.shtml) has just completed surveying its members (as it has done in the past) to understand budgets for 2011. Results have not been tabulated yet, but we would expect the survey may show flat or declining budgets once again (they declined by 4 to 5% last year - **Exhibit 3** and **Exhibit 4**), and possibly the first decline in aggregate materials acquisitions ever.

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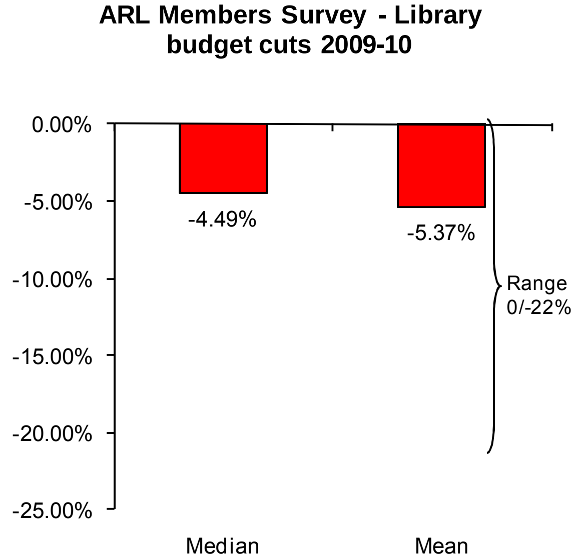
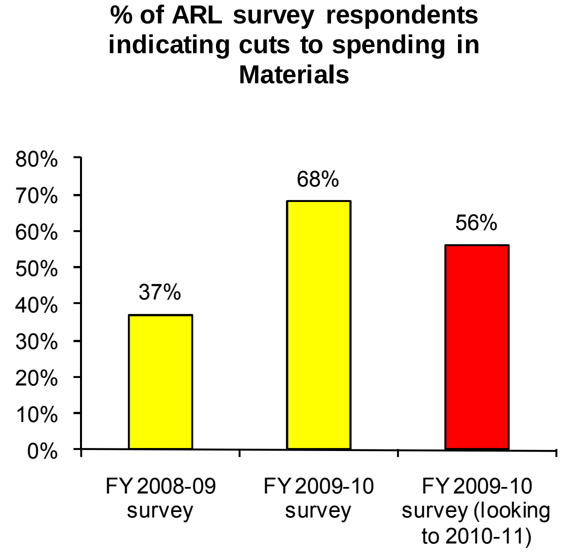
Exhibit 3
The ARL members which responded to last year's survey were seeing their overall budget cut by about 5% in FY 2009-10



Source: Interviews

Exhibit 4
One year ago, the percentage of ARL members seeing cuts to their budgets for Materials had doubled from the previous year



Source: Interviews

We do not believe that every country is in the same position: Sweden and China, for example, appear to have sufficient funding to increase their spending on STM journals in 2011 by 4 to 5%. Overall, however, we think that a combination of targeted cancellations and pressure to manage down increases will limit Elsevier's Science and Technology organic growth in 2011 to levels below the 3% achieved in 2010 (**Exhibit 5**). Incidentally, we believe that consensus expects slightly lower organic growth in 2011, of around 2-2.5%.

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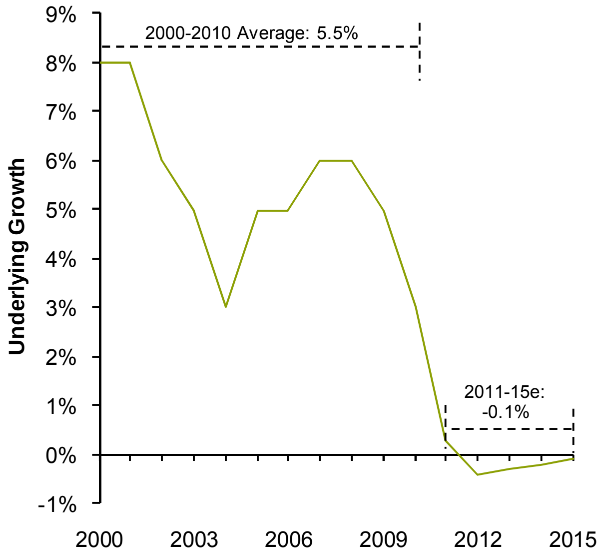
Exhibit 5

We expect Elsevier's Science and Technology business' organic growth in 2011 to be negligible, and then to decline between 2012 and 2015



Source: Company reports, Bernstein estimates

Note: 2000&2001 underlying growth rates includes Health Science

The question is then what happens starting in 2012, when consensus expects a step up of the organic growth rate from 2% to 3.5-4.0%. We think that – in the current political environment – US State universities and the university libraries of some major European countries (UK, Italy, Spain, etc.) will not see increases in funding and may see further cuts, setting the stage for drastic cuts to materials spending after 2011; private universities in the US which are most dependent on endowments may also face further budget cuts. We believe marginal organic growth is the most likely outcome, but that the risk of a major shortfall in revenues continues to rise as time goes by and universities scrutinize with increasing attention their spending.

The "Big Deal" commercial model worked well for over a decade, but is becoming unsustainable in the current funding environment.

Librarians have been complaining for a long period of time that the "Big Deal" contract model (in which publishers granted academic libraries the electronic access to most or all their journals at a substantial discount to retail subscription rates) was constraining their resources to fund other areas of activity. Ultimately, however, academic libraries have continued renewing (and funding) "Big Deal" contracts: Elsevier claims that less than 10% of their revenues derive from individual subscriptions. We think this will become less tenable over time, as librarians are increasingly constrained by budgets which cannot keep pace with the spending increases called for by contracts. This means that librarians will increasingly scrutinize the portfolio of publications of each publisher and appraise the usefulness of each title on the basis of factors like usage and Impact Factor, which opens up the risk that librarians may decide they can "live" without the lower "value" publications.

The "Big Deal" model is predicated on bundling together as many journals as possible and offering libraries the bundle for one price which is negotiable and which is typically lower than the individual subscription price of each journal. Superficially, this looks like a great deal for libraries, since they receive access to many more journals they would be able to afford if they had to acquire individual subscriptions to each of them. Unfortunately, the convenience is fictitious: the savings exist only as long as a library was going to acquire all (or at least many) the journals in the first place. Since none of the publishers has only "must have" titles, the effect is to sign up libraries to pay for both what they want and what – conceivably – they would not really want. It is difficult to estimate what percentage of the titles published by Elsevier is "must have" for a significant number of libraries. The company publishes about 2,400 journals, and claims that about 50% of its titles are number one or two in their respective sector and virtually all of them are in the top ten, but definition of sectors can be cut narrowly enough to shorten the list of journals to the point where it becomes irrelevant.

So, how many of Elsevier's journals are "must have"? The answer of course varies by institution, but we think that it is ultimately a function of three elements: the focus of the academic institution (research vs. teaching, as well as in which disciplines), the readership of the publication (more or less usage, at least relative to other journals in the same discipline) and the quality of the publication (typically measured through the Impact Factor).

The focus of the institution is obviously specific to each customer, so we will set it aside for a moment. Usage numbers are extremely difficult to find for outsiders, although we suspect that a significant number of publications, on average, have very limited actual use. As an example, New Mexico State University publicly announced in September 2010 that it had decided to discontinue two "Big Deal" contracts which would lead to the loss of access to 1,333 journals, and made available information on the contracts it had discontinued. The university, which has an enrolment of about 23,000 students and a faculty of about 700, offers 21 doctoral programs, primarily in science, engineering and agriculture. On average, in 2010 the discontinued journals had been accessed, by mid-September, 15.6 times, but the median publication had been accessed only 5 times. Two thirds of the publications (67.6%) had been accessed less than 10 times, which means that only one third had been accessed more than once a month on average; less than one in five (16.9%) had been accessed more than twice a month on average; only 8.8% of the journals had been accessed, on average, once a week (and only 6 journals - 0.4% of the journals cancelled - had been accessed once a day on average) (**Exhibit 6**).

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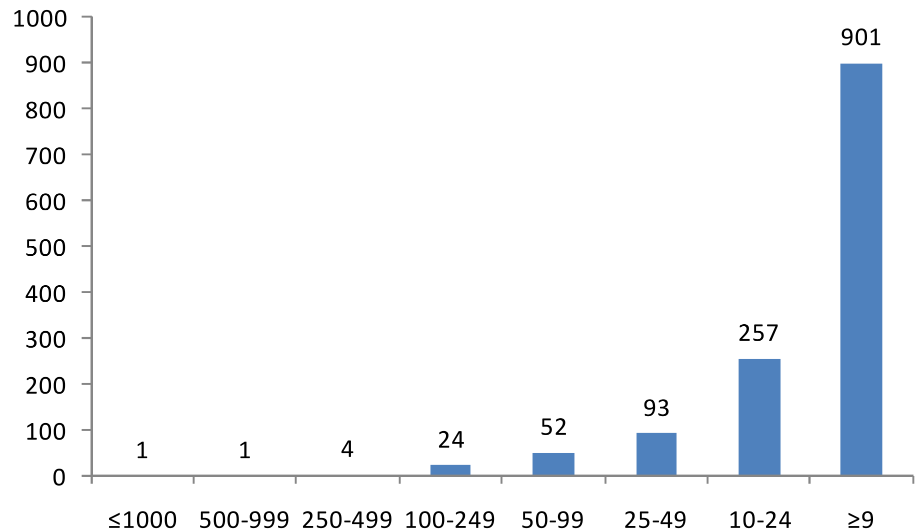
Exhibit 6

More than two thirds of the journals cancelled by NMSU at the end of 2010 were accessed once a month or less; less than 9% had been accessed once a week or more.



Source: NMSU Library, Bernstein analysis

These numbers, of course, can be read in many different ways: it can be argued that the average readership of the journals was low because of many possible factors (from the average quality of the journals to the limited number of researchers and doctoral students in many of the disciplines involved) and that other institutions would see much higher usage for the same titles. We would not disagree with any of these arguments, but the real issue is ultimately whether any academic library can justify "Big Deal" contracts in which 13% of the journals account for 67% of the readership.

Universities which have started to renounce their "Big Deals" seem able to cope, and this represents a significant threat to the "Big Deal" model

We have spoken to a large university which discontinued two of its "Big Deals" and found that their savings are large (in the 30% region), and the rate of complaint from the users is minimal. While a number of "best practices" may be required to accomplish similar results, we think that academic and research libraries around the world will pay increasing attention to these experiences, potentially triggering a stampede of discontinued packages in the years to come.

The university we have spoken to (one of the top 100 universities in the world in the 2010 QS World University rankings) decided to discontinue two of its packages at the end of 2010. The library was facing a 10% budget cut, which came on top of cuts in the previous two years which amounted to about an additional 5% reduction. Materials purchases (books and journals) account for about 45% of expenditures, and journals account for 40% of materials spending, or 18% of total spending (this number is roughly in line with the low end of journals budgets: the range usually reported is 19 to 28%, depending on the type of institution). One of the cancelled packages was highly specialist in one discipline, while the second one was with one of the top three STM publishers in the world, and therefore included publications in a wide array of disciplines. This second package accounted for about 4.5% of the materials budget and included a large

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enough number of titles that the library at first offered to renew it, asking for a 15% reduction in total spending, which would have rolled out its cost to about where it stood in 2007, before budget cuts started. When the publisher refused to accept lowering the price, the library decided to discontinue the purchase altogether and subscribe to individual titles at list prices. The titles which "survived" the cut were chosen on the basis of usage; this criterion was tempered by conversations with the faculty to ensure that titles with low usage numbers, but critical to the work of the faculty, would be safeguarded. This entailed a significant loss of titles for the library (according to our estimates, about 93.5% of the titles were lost to the library) and of revenues for the publisher (the total revenues this publisher now earns from this university have declined by 29%, according to our estimates).

The key, however, is the response of the faculty. To some extent, these are still early days, as the cuts have been in place for just over two months. However, with an estimated user community of about 5,000 between faculty and graduate students, the library has received, so far, two complaints. The library staff, which had braced itself for many more complaints, attributes this low rate to its extensive communications programs, as well as its work with the departments to ensure that "must have" publications would continue to be acquired. Complaints are still expected to rise in the next months, but the clear conclusion of the library staff is that – with appropriate communications – a major cuts program is feasible. The university is now starting to review several other packages which expire at the end of 2011, and is definitely more comfortable than six months ago about its negotiating position with the publishers.

The best case scenario for Elsevier is a repeat of 2010 for several years, with limited organic growth and periodic flare ups of conflict with individual libraries (or, in some case, countries); widespread decision to discontinue "Big Deals" would lead to revenue and earnings decline

Our base case for Elsevier now forecasts that annual organic growth will remain at 2% in 2011, then decline to a 1 to 2% range between 2012 and 2015 (at the very least), as we have seen in **Exhibit 5** and as we detail further in **Exhibit 7**. We have derived our 2% decline 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 (**Exhibit 8**). These cuts should lead to lower price inflation, and so we have assumed there will be 0% growth in the STM market from the other universities within regions where "Big Deals" have been discontinued. We think that the Rest of the World and corporate sales represent about 50% of the global market; we expect the STM market to grow 5% in these countries, resulting in a net impact of just over 2% decline in the STM market.

We think that consensus numbers, on the other hand, are for growth to accelerate back to 4% by 2013 (**Exhibit 9**), leading to operating profit for the division that is respectively 1.7 and 3.9% higher than our forecasts for 2012 and 2013 (**Exhibit 10**); this differential alone is worth a difference of 1.2p and 2.4p of EPS in 2013 and 2014 respectively. In other words, our lower organic growth forecast drives an EPS that is respectively 2.4% and 3.3% lower than if we agreed with consensus expectations.

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Exhibit 7

We now 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	1018	1014	1011	1009	1008
Journals as % of S&T	78%					
Elsevier S&T growth rate		0.3%	-0.4%	-0.3%	-0.2%	-0.1%
of which Journals	791.7	783.783	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	1051	1090	1130	1173	1219
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	1032
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

Exhibit 8

We expect the discontinuation of "Big Deals" will lead to a 2% decline in global journal revenue

Region	% Universities Affected	% Cut	% Growth	Region's Global Market Share	Impact on STM
UK	50.0%	30.0%	0.0%	5.0%	-0.75%
USA	30.0%	30.0%	0.0%	35.0%	-3.15%
Western Europe	25.0%	30.0%	0.0%	10.0%	-0.75%
Rest of World	0.0%	0.0%	5.0%	50.0%	2.50%
Total	**15.5%**	**--**	**--**	**100.0%**	**-2.15%**

Source: Interviews, Bernstein estimates and analysis

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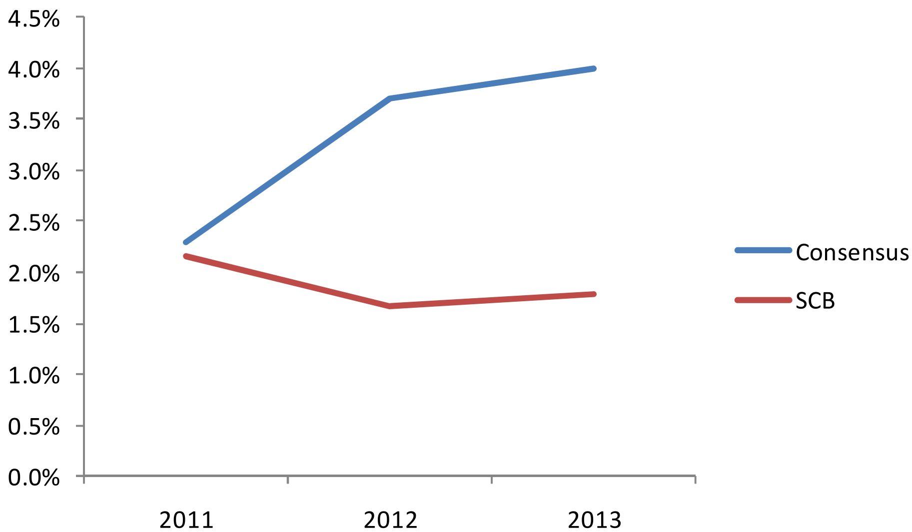
Exhibit 9

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 10

…leading us to forecast an Operating Profit for the division which is 1.7 and 3.9% below consensus in 2012 and 2013 respectively

£ million	2010A	2011E	2012E	2013E
SCBe Operating Profit	724	734	752	769
Y-o-Y growth		*1.4%*	*2.5%*	*2.3%*
Consensus Forecast Operating Profit	724	735	765	800
Y-o-Y growth		*1.5%*	*4.1%*	*4.6%*
Δ SCBe vs. Cons		-0.1%	-1.7%	-3.9%

Source: Interviews, Bernstein estimates and analysis

We believe however that 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 and a 15% reduction in Health Sciences journal spending phased between 2012 and 2015. Cuts of this magnitude could happen if the academic community at large took notice of cuts. In this scenario it could prove difficult to sustain many journals, which would in turn lead to more cancellations. While we still think the probability of a meltdown is low (perhaps in the region of 25%), it is clearly higher than zero and is rising with universities making deep cuts and experiencing only minor discomfort. According to our model, this decline in revenues would lead to an 8 to 14% reduction in the Reed Elsevier's 2015 EPS (from 54.1p (on a constant currency basis from 2010) to 46.7p or 49.6p); depending on how aggressively Elsevier would pursue cost reduction.

Our model shows that a 25% cut by 2015 in Science and Technology journal revenues and a 15% cut in Health Sciences journal revenues relative to our current forecast would reduce Elsevier's total revenues by

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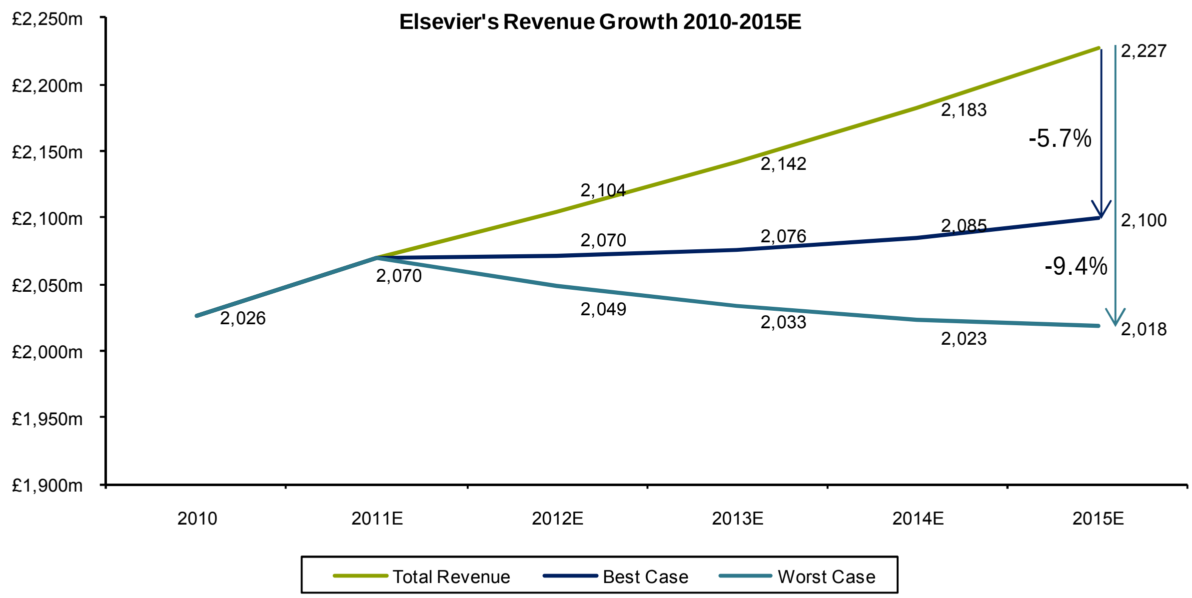
9.4% (**Exhibit 11**) and depress Elsevier's overall operating margin from 36.9% to 30.4% in that year (**Exhibit 12**). Our best case, if there is a major movement to cut spending, is to see aggregate cuts in the 15% region for Science and Technology and 10% for Health Sciences. Alternatively, if the cuts are deeper but Elsevier chooses to discontinue marginal journals, the impact would be effectively the same as in our best case, limiting the decline of revenues to 5.7% (**Exhibit 11**) and the contraction of operating margin from 36.9 to 33.1% (**Exhibit 12**). This decline, in turn, would translate into a steep decline in the overall operating margin for Reed Elsevier: according to our model, in 2015 the overall operating margin of Reed Elsevier would decline from 27.2% to 24.8% (in this case again, the impact could be cushioned by cost reduction, leading to smaller decline to 25.7%) (**Exhibit 13**).

Exhibit 11

A 25% decline in Science and Technology journal spending, combined with a 15% reduction in Health Science journal spending, would cause a 9.4% reduction in revenue for the division in 2015, although a 12.5% cost reduction program would limit the decline to 5.7% …

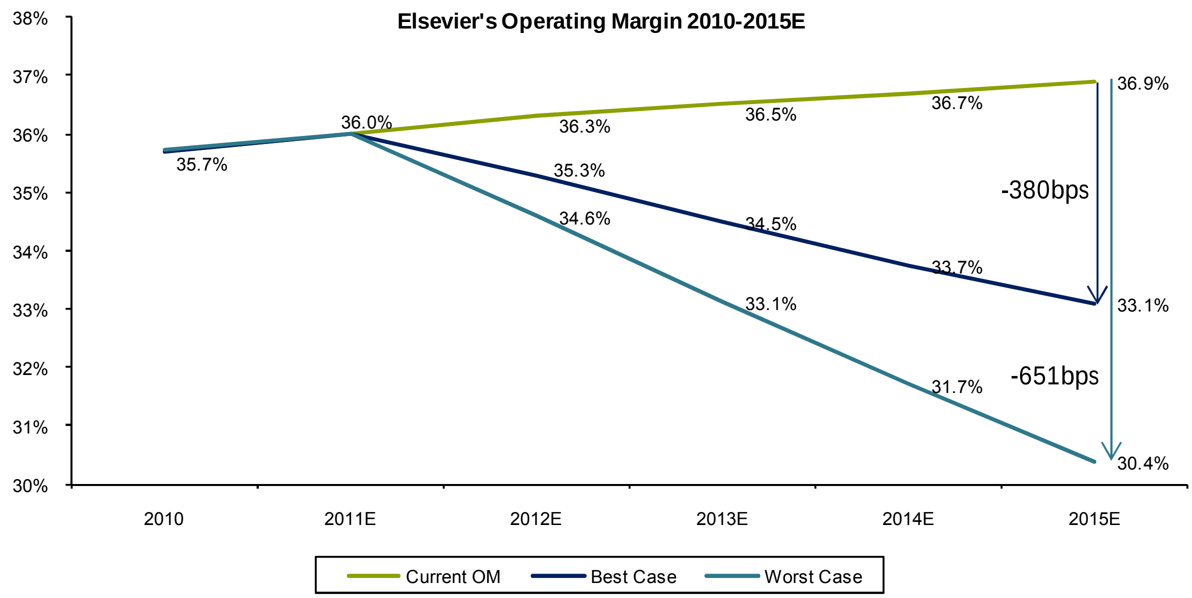


Source: Company reports, Bernstein estimates and analysis

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

Exhibit 12

…causing Elsevier's operating margin to contract from 36.9 to 30.4%; again, a 12.5% cost reduction program would limit the decline to 33.1%…

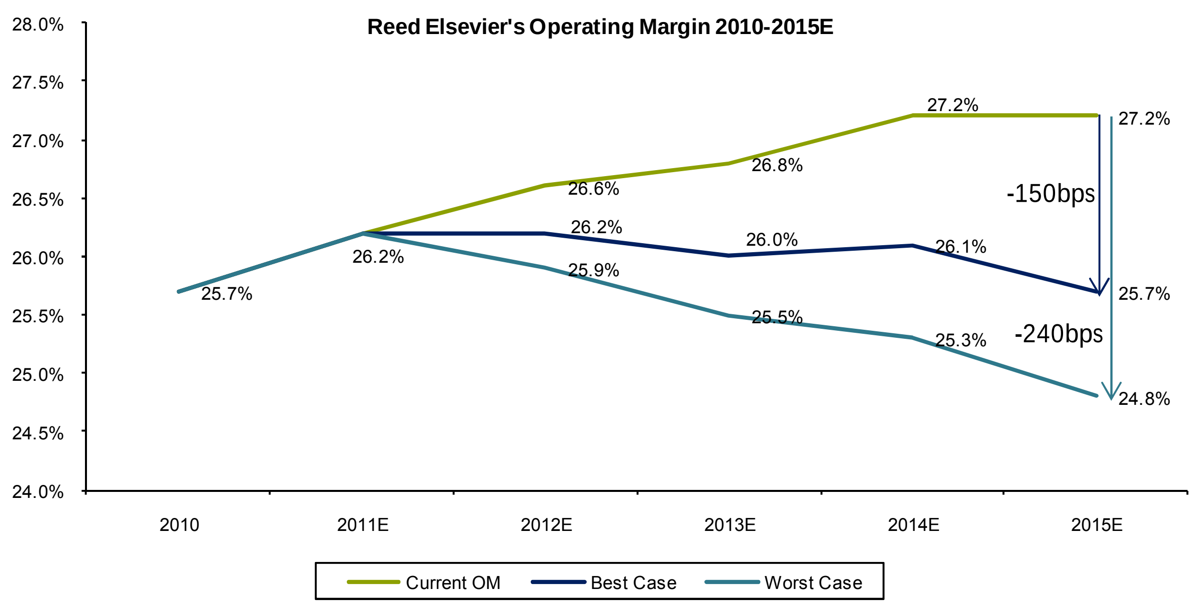


Source: Company reports, Bernstein estimates and analysis

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

Exhibit 13

…the overall Reed Elsevier operating margin would decline from 27.2% to 24.8%



Source: Company reports, Bernstein estimates and analysis

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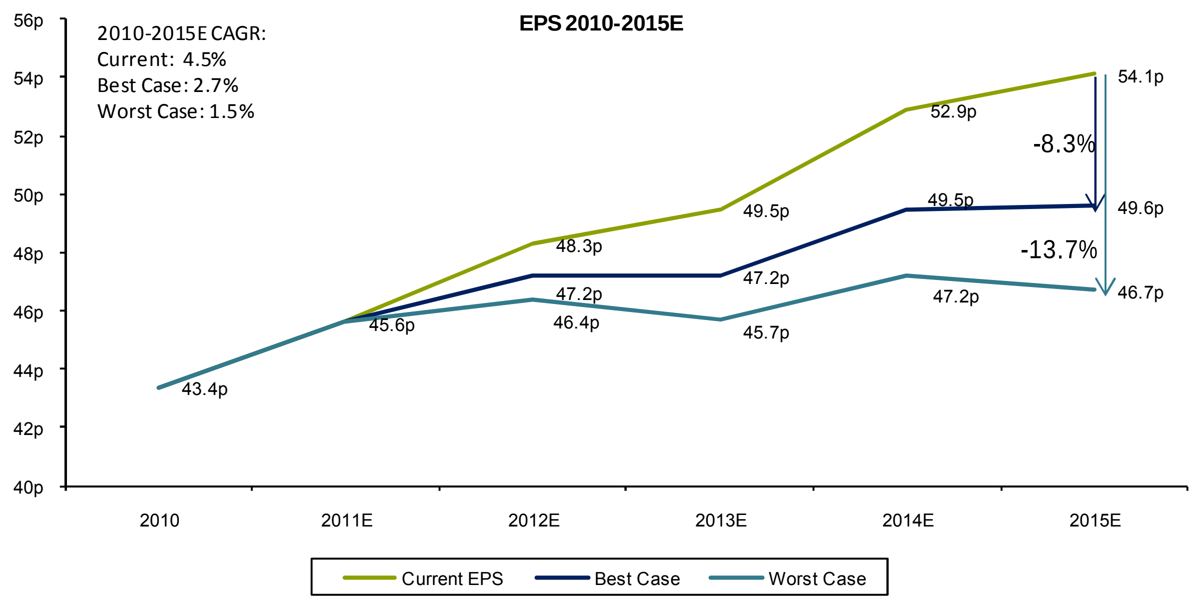
The consequences for investors could be severe: our model predicts that EPS would decline by 8.3% to 13.7%, from 54.1p to 46.7-49.6p, depending on the execution of a cost cutting plan (**Exhibit 14**).

Exhibit 14

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



Source: Company reports, Bernstein estimates and analysis

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

Investors should start to ask management what is their plan B, since the assumption that the current commercial model will prove sustainable looks increasingly uncertain

Is there a Plan B?

The management of Elsevier has known for many years that – at least to some extent – there was a potential issue with the existing commercial model. On the 20th November 2005 the company staged an Investor Seminar dedicated to presenting the different areas of activity of Elsevier. In one of the slides, titled "Attractive growth markets", management showed various quantitative measures of the drivers of the growth of science and technology publishing: global university funding (7-8% CAGR), global corporate R&D spend (5-6% CAGR), US total academic R&D spend (CAGR 7%). There was a note at the bottom of the slide (*"although library budgets have not kept pace:1-3%"*) which should have alarmed investors and management (**Exhibit 15**). Clearly, we were just as unable to focus on that line: in December 2007 we wrote "*As a result of pressure from the academic community, Reed Elsevier has moderated its pricing in the last couple of years. Despite this pressure, Elsevier has still enjoyed a healthy underlying growth rate of around 5%...We expect these levels of revenue growth to be sustained going forward*".

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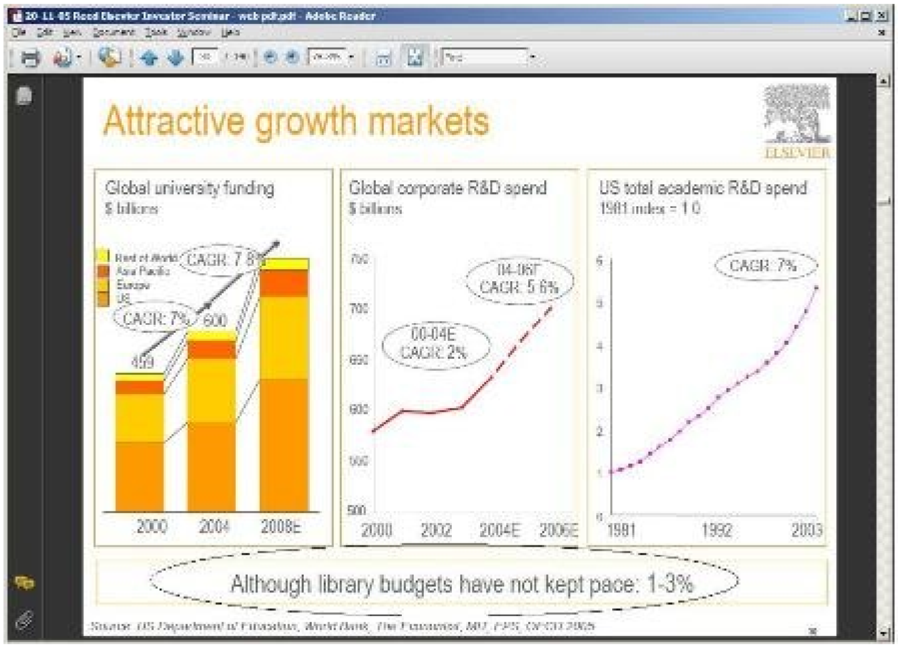
Exhibit 15

The management of Elsevier was aware back in 2005 that library budgets were not keeping pace with publishers revenue growth



Source: Reed Elsevier Investor Seminar, November 2005

The customer may not be always right, but it is somewhat dangerous to assume that the customer is always wrong. For many years the academic community has been arguing that the inflation rate for academic journals was becoming unsustainable, but the commercial publishers seem to have chosen to ignore the message. It is unhealthy for any industry to have its customers actively pursue the overthrow of their key current suppliers, which is exactly what is happening in scholarly publishing. It is unhealthy that the association which groups Elsevier's core North American customers (the ARL) list among its "major Initiatives" the support of SPARC (The Scholarly Publishing and Academic Resources Coalition), an organization which defines its goal *"to stimulate the emergence of new scholarly communication models that expand the dissemination of scholarly research and reduce financial pressures on libraries"* (i.e. subvert Elsevier's current economic model).

We think investors should ask the management of Reed Elsevier to articulate why they believe that neither of the two options formulated to the *Wall Street Journal* by David Prosser, the Executive Director of Research Libraries UK and quoted at the beginning of this document are certainly not going to happen. Alternatively, investors should start asking "what is the plan B", in case a significant number of university and research libraries start demanding – like the library we mentioned earlier in this call – 15% reductions in their contracts or else cut their spending by 30%, since – as we have seen in **Exhibit 11** to **Exhibit 14** – the likely implications for shareholders would be significant. The management of Reed Elsevier has argued that, with science funding rising around the world, it is only a matter of tapping broader university and R&D budgets – in essence what they argued in the slide from the investor day in 2005 but have been unable to do in the past five years. In reality, with all university budgets under pressure (and not just libraries), it is unclear that a return to 5%+ revenue increases will be possible for many years. It is also unclear whether it is a good idea to ask departments and faculty to fund the purchase of periodicals: Professor Stuart Shieber, who directs the Office for Scholarly Communication of Harvard University, has convincingly argued in the

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past that the crisis in the dissemination of academic research has been made possible by the "moral hazard" implicit in the fact that users (faculty and researchers) did not have information about the actual price of the information they were accessing. If Shieber is right, the last thing publishers may wish to do is to communicate explicitly to the users what is the price the institutions pay for STM journals.

Can Reed Elsevier afford its current valuation?

The structural issues that we have outlined in this call are likely to play out over time, rather than in one year (because the multi-year nature of the Big Deal contracts means that they will not be discontinued all at once), the valuation of Reed Elsevier is more challenging than many investors realize.

While consensus P/E for 2011 is only an 8.2% premium to the MSCI Europe, the stock looks more expensive on an EV/EBITDA basis (a 15.1% premium) because of the relatively high debt. This means that a string of disappointing results in the largest and most visible business of the company could disproportionately affect the equity valuation. In addition, our base case EPS for 2011 and 2012 (45.2p and 47.9p respectively, stands 1.7% and 5.3% below consensus (**Exhibit 16**); our best and worst case scenarios in case of massive discontinuation of Big Deals would stand even further below consensus (**Exhibit 17**)

Exhibit 16
Our current EPS stands 1.7 and 5.3% below consensus for 2011 and 2012…

	2010A	2011E	2012E
SCBe EPS	43.4p	45.2p	47.9p
Y-o-Y growth		*4.1%*	*6.0%*
Consensus Forecast EPS	43.4p	46.0p	50.6p
Y-o-Y growth		*6.0%*	*10.0%*
Δ SCBe vs. Cons		-1.7%	-5.3%

Source: Bloomberg, Bernstein estimates and analysis

Exhibit 17
…and significant discontinuation of Big Deals could lead to even lower EPS

	2010A	2011E	2012E
SCBe EPS Worst Cast	43.4p	45.2p	46.0p
Y-o-Y growth		*4.1%*	*1.8%*
SCBe 12.5% Cost Efficiency on Worst Case	43.4p	45.2p	46.8p
Y-o-Y growth		*4.1%*	*3.5%*
Consensus Forecast EPS	43.4p	46.0p	50.6p
Y-o-Y growth		*6.0%*	*10.0%*
Δ SCBe Worst Case vs. Cons		-1.7%	-9.1%
Δ SCBe 12.5% Cost Efficiency on Worst Case vs. Cons		-1.7%	-7.5%

Source: Bloomberg, Bernstein estimates and analysis

We also think that the rest of the portfolio, characterized by a structurally challenged legal research business (LexisNexis Legal & Professional) and some modestly performing cyclical businesses (RBI and Exhibitions) is unlikely to offset the disappointments we expect from Elsevier. The LexisNexis Risk

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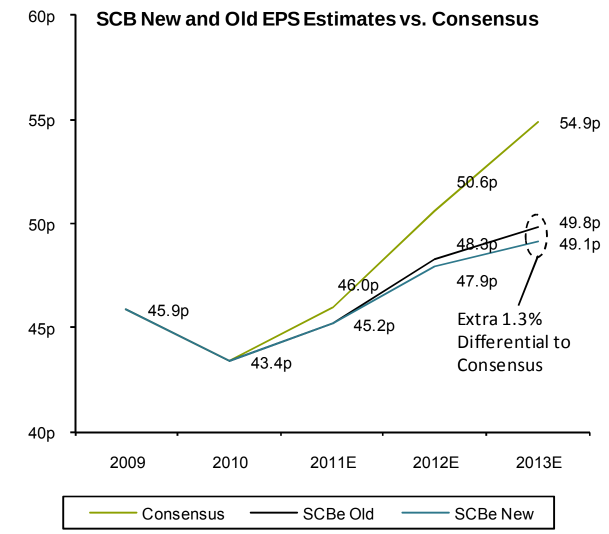
Solutions business looks poised to continue performing well, but it only represents 15.3% percent of revenues and 22.6% of profits, and is therefore too small to offset the problems affecting the rest of the portfolio.

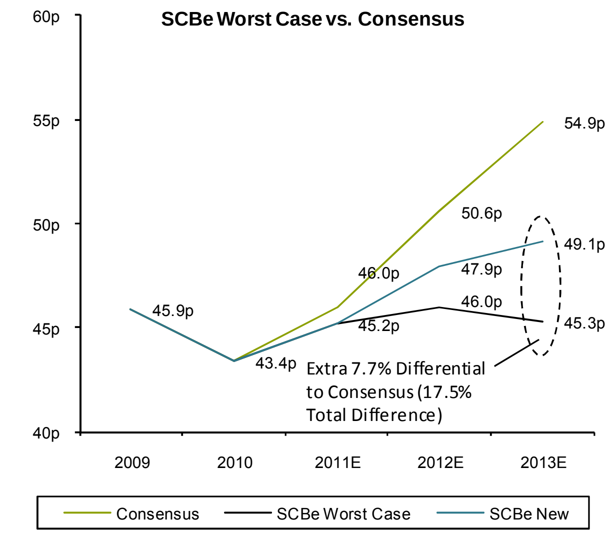
The incremental impact of lowering our Elsevier numbers is relatively modest (**Exhibit 18**), but we are also concerned that the risk of numbers deteriorating further continues to rise, which would lead to a dramatic underperformance (**Exhibit 19**).

Exhibit 18
Our gap with consensus EPS has widened only modestly as a result of our new projections…



Source: Bloomberg, Bernstein analysis

Exhibit 19
…but the downside if Big Deals are cancelled is large



Source: Bloomberg, Bernstein analysis

In the absence of workable alternatives that protect revenues if Big Deals are discontinued *en masse*, we are downgrading Reed Elsevier to Underperform. Our target prices decline from 500p to 450p for the Plc and from €9.00 to €8.00 for the NV stock.

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Exhibit 20

Reed Elsevier – Income Statement

£ million	2010A	2011E	2012E	2013E	2014E	2010-14 CAGR
Revenues	6,055	5,955	6,150	6,226	6,456	1.6%
Operating costs (before goodwill and except.)	-4,508	-4,413	-4,538	-4,579	-4,728	1.2%
Corporate costs	-34	-36	-38	-40	-42	5.6%
Unallocated pension credit	26	20	20	20	20	-6.3%
Total adjusted operating profit	1,555	1,557	1,629	1,666	1,750	3.0%
Adjusted operating margin	26%	26%	26%	27%	27%	
Net interest	-276	-232	-240	-257	-257	-1.8%
Adjusted profit before tax	1,279	1,325	1,390	1,409	1,493	3.9%
Taxation paid	-290	-304	-319	-324	-343	4.3%
Adjusted net income (total operations)	983	1,014	1,064	1,079	1,143	3.8%
Adjusted net income (continuing operations)	983	1,014	1,064	1,079	1,143	3.8%
Adjusted EPS (basic)						
PLC (£)	0.434	0.452	0.479	0.49	0.52	4.8%
NV (€)	0.78	0.82	0.87	0.89	0.95	5.1%

£ million	2010A	2011E	2012E	2013E	2014E	2010-14 CAGR
Revenue	**£6,055**	**£5,955**	**£6,150**	**£6,226**	**£6,456**	**1.6%**
o/w Elsevier	£2,026	£2,037	£2,071	£2,107	£2,147	1.5%
o/w LexisNexis	£2,618	£2,584	£2,642	£2,709	£2,783	1.5%
o/w Reed Business	£1,411	£1,334	£1,438	£1,409	£1,526	2.0%
o/w Exhibitions	£693	£639	£722	£671	£759	2.3%
o/w Reed Business Information	£718	£695	£716	£737	£767	1.7%
Adjusted Operating Profit (divisions only)	**£1,563**	**£1,573**	**£1,647**	**£1,686**	**£1,953**	**5.7%**
o/w Elsevier	£724	£734	£752	£769	£788	2.2%
o/w LexisNexis	£592	£584	£597	£626	£657	2.6%
o/w Reed Business	£247	£255	£298	£290	£327	7.3%
o/w Exhibitions	£158	£146	£172	£153	£181	3.4%
o/w Reed Business Information	£89	£109	£126	£137	£146	13.3%
Adjusted Operating Profit margin	**26%**	**26%**	**27%**	**27%**	**30%**	
o/w Elsevier	35.7%	36.0%	36.3%	36.5%	36.7%	
o/w LexisNexis	22.6%	22.6%	22.6%	23.1%	23.6%	
o/w Reed Business	17.5%	19.1%	20.7%	20.6%	21.4%	
o/w Exhibitions	22.8%	22.8%	23.8%	22.8%	23.8%	
o/w Reed Business Information	12.4%	15.7%	17.6%	18.6%	19.1%	
Organic Revenue Growth	**1.6%**	**0.9%**	**3.3%**	**1.2%**	**3.7%**	
o/w Elsevier	2.0%	2.1%	1.7%	1.8%	1.9%	
o/w LexisNexis	1.0%	1.4%	2.2%	2.6%	2.7%	
o/w Reed Business	2.2%	-1.9%	7.8%	-2.0%	8.3%	
o/w Exhibitions	8.0%	-7.0%	13.0%	-7.0%	13.0%	
o/w Reed Business Information	-2.0%	3.0%	3.0%	3.0%	4.0%	

Source: Company reports, Bernstein estimates and analysis

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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 21**).

Exhibit 21
Valuation Methodology

Company	Rating	Currency	Market Cap	8-Mar-11 Price	EPS CAGR 2010-13E	2011 EPS	2011 P/E	Relative P/E Multiple	Target Relative P/E Multiple	Target Price	% Upside Downside
Reed Elsevier PLC	U	GBP	£6,554	547.5p	4.2%	45.2p	12.1x	110%	90%	450p	-18%
Reed Elsevier NV	U	EUR	€ 6,915	€ 9.46	4.5%	€ 0.82	11.5x	105%	90%	€ 8.00	-15%
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.

  Market-Perform: Stock will perform in line with the market index to within +/-15 pp in the year ahead.

  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.
- As of 03/07/2011, Bernstein's ratings were distributed as follows: Outperform - 43.6% (1.6% banking clients) ; Market-Perform - 48.7% (1.4% banking clients); Underperform - 7.7% (0.0% banking clients); Not Rated - 0.0% (0.0% banking clients). The numbers in parentheses represent the percentage of companies in each category to whom Bernstein provided investment banking services within the last twelve (12) months.
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- In the next three (3) months, Bernstein or an affiliate expects to receive or intends to seek compensation for investment banking services from REL.LN / Reed Elsevier PLC, REN.NA / Reed Elsevier NV.

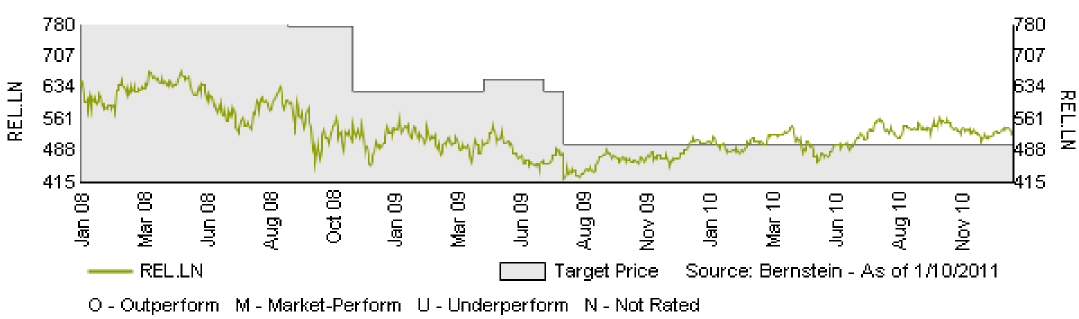
12-Month Rating History as of 03/08/2011

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

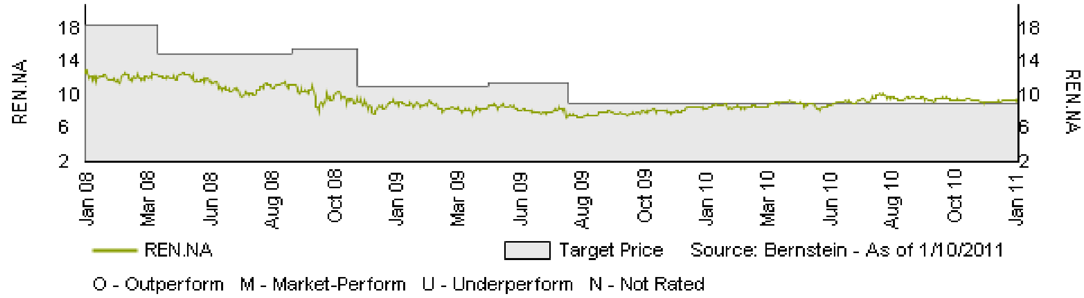
REL.LN / Reed Elsevier PLC

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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