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# Reed Elsevier: Goodbye to Berlin - The Fading Threat of Open Access (Upgrade to Market-Perform)

***Rating Change / Target Price Change / Estimate Change in Bold***

| Ticker | Rating | CUR | 23 Sep 2014 Closing Price | Target Price | TTM Rel. Perf. | EPS 2013A | EPS 2014E | EPS 2015E | P/E 2013A | P/E 2014E | P/E 2015E | Yield |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| REL.LN | **M** | GBp | 989.50 | **1000.00** | 10.3% | 54.00 | **54.87** | **58.65** | 18.3 | 18.0 | 16.9 | 2.8% |
| *OLD* | U | | | 700.00 | | | 56.34 | 59.83 | | | | |
| REN.NA | **M** | EUR | 17.75 | **19.00** | 11.1% | 0.99 | **1.04** | **1.14** | 17.9 | 17.1 | 15.6 | 3.0% |
| *OLD* | U | | | 12.00 | | | 1.07 | 1.15 | | | | |
| PSON.LN | O | GBp | 1214.00 | 1300.00 | -13.3% | 70.07 | 65.42 | 74.87 | 17.3 | 18.6 | 16.2 | 4.5% |
| MSDLE15 | | | 1404.64 | | | 86.48 | 91.52 | 103.17 | 16.2 | 15.3 | 13.6 | 3.2% |

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

## Highlights

- **When we downgraded Reed Elsevier to Underperform in 2011, we thought that budget constraints would slow the growth of Elsevier's journal business below consensus.** At the time, the outlook for the years to come was for continued cuts in academic library budgets, and we thought unavoidable that libraries would respond by progressively abandoning "Big Deal" contracts in order to achieve substantial savings, facilitated by the limited number of journals which really matter to readers.
- **In addition, in 2012 we also thought that political intervention both in Europe and in the UK would force a shift to full Open Access (OA) journals, with negative consequences on the economics of Elsevier.** Years of lobbying by various constituencies brought the UK first, then the European Union, and finally the Obama administration to adopt policies and, in the case of the UK and the EU, funding to support a transition to OA. By our estimates at the time, a full transition to Gold OA could lower Reed Elsevier's overall operating profit by an estimated 6 to 22%.
- **11 years after the Berlin Declaration on Open Access, however, the rise of Open Access appears to inflict little or no damage on the leading subscription publishers.**
  - **Subscription publishing appears in good health.** Both Reed Elsevier and Wiley have outperformed the respective markets in the past year, supported (at least in part) by the performance of the journal businesses.
  - **The threat posed by OA seems to recede.** OA policies have proved right, so far, the critics who argued that they would not threaten the status of subscription publishers. The hybrid model deployed by subscription publishers to meet the requirements of the UK government is not threatening in any visible way the subscription model of the journals; the rate of adoption of deposit policies for US federal agencies, and the embargo period of 12 months also protect the position of subscription publishers.
  - **OA funding may in fact be adding to the profits of STM.** It remains to be seen whether the publishers can provide evidence that they are not double dipping (i.e. pocketing Author Publication Charges (APCs) for OA publishing without lowering their subscription revenues). Absolute verification may prove in fact impossible anyway, but the publishers seem to use practices which leave wiggle room to keep at least some of the money.

European Media

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- **Not all is well, however.** There are, however, some issues which counsel some caution. The risk of a return to budget cuts, should another recession start, is not inconsequential: overall library budgets do not seem to keep pace with the growth in materials spending. In addition, the relative lack of transparency in how APCs are returned to libraries adds to the concerns of a political backlash (particularly in the case of a downturn).

- **Recent developments (like the filing for protection from creditors of Swets, a subscription agency) only reinforce the sense that industry forces will help the leading subscription publishers.** The recent difficulties of Swets, one of the two leading subscription agencies, both reflect the evolution of the industry (large publishers increasingly serving directly many of the libraries; the shift from physical to digital journals) and threaten to usher further consolidation of the industry. This would favour the larger publishers (like Elsevier).

- **The rest of the portfolio is either in good health (Risk, Exhibitions – as we have always maintained) or challenged but ultimately too small to matter (Legal).** We have liked most of the rest of the portfolio of Reed Elsevier. The only business we do not like is Legal, but we think investors have now resigned themselves to slow growth for some time to come in this business.

- **The valuation is in line with historic averages and we believe it reflects adequately the current operating performance of the company.** As a result, we do not think the stock could decline to a 20% discount to the MSCI and believe the historic average 15% premium is an adequate valuation for the company in its current situation. In this context, the target price for the UK and the Dutch stocks is respectively £10.00 and €19.00, which require us to raise the rating to Market-Perform.

- **We continue to prefer Pearson.** Pearson remains our favourite publisher, thanks to its transformational strategy and the opportunity to build a much larger business in the years to come. The cyclical headwinds which have plagued the company for 2.5 years are abating, and 2015 should see substantial EPS growth (we expect it to rise by 14.4% in 2015). With a valuation that is substantially in line with that of Reed Elsevier PLC this year but much faster EPS growth next year (14.4% vs. 6.8% for REL.LN) Pearson looks much more attractive.

**Investment Conclusion**

Reed Elsevier looks less vulnerable to structural challenges than we had anticipated when we downgraded the stock in 2011. We think that academic librarians, as long as they receive sufficient funding, will continue to renew "Big Deals", and the OA policies adopted by governments around the world appear deferential to the interests of subscription publishers. As a result, we think the current organic revenue growth of Elsevier is sustainable, and this growth – in turn – supports a valuation in line with current share prices. As a result, we are upgrading the stock to Market-Perform, with new target prices of £10.00 and €19.00 respectively. We still counsel caution on the stock, however, as the risk to academic budgets in a possible recession is not insignificant, and there is a reputational risk if the publishers were to avoid adopting practices which demonstrate clearly they are not using public funding of OA to raise their profits (contradicting their pledges to not do so).

We continue to prefer Pearson, which has a similar valuation, is approaching a bottom in its performance, and should see much faster EPS growth next year (14.4% vs. 6.8% for REL.LN). Pearson is pursuing a transformational strategy which could make it a much larger company in a few years' time.

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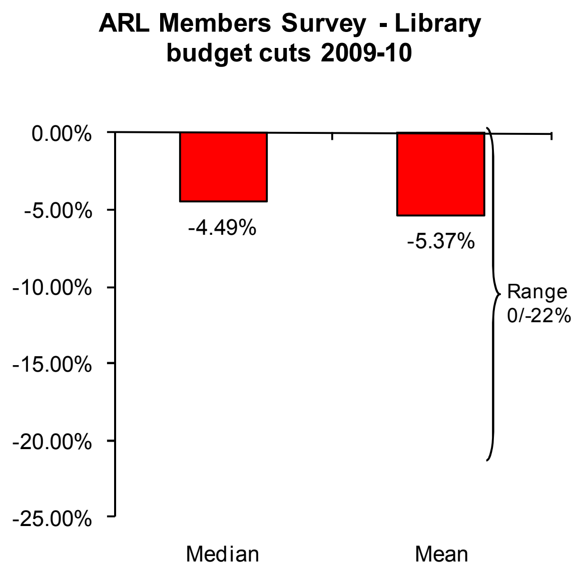
## Details

### When we downgraded Reed Elsevier to Underperform in 2011, we thought that budget constraints would slow the growth of Elsevier's journal business below consensus

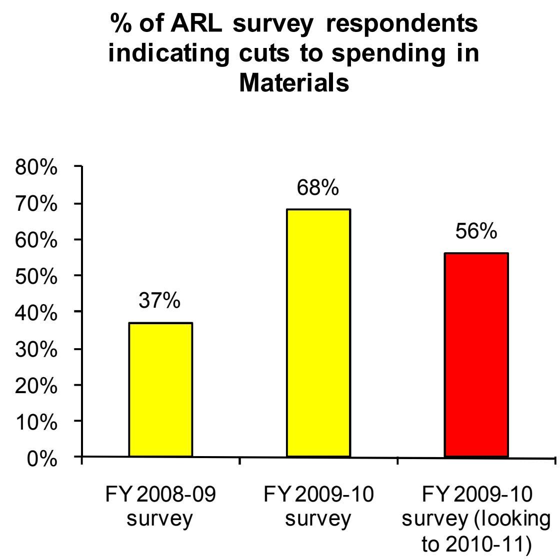
When we downgraded Reed Elsevier in March 2011[1], we focused our scepticism on the revenue growth outlook for the Scientific, Technical and Medical segment (STM), which is still referred to - within the publishing industry – with its old name, Elsevier. In a nutshell, we thought that the collections model (familiarly known as "Big Deals"), in which publishers offer electronic access to a vast number of journals bundled into one price, was going to become untenable. This prediction was based on the twin pressures of academic libraries' budget constraints (**Exhibit 1** and **Exhibit 2**) and the uneven value of journals, with a handful of titles driving the bulk of the readership, while the rest are hardly, if ever, accessed (**Exhibits 3** to **Exhibit 5**). We thought that these forces would lead a rising number of librarians to purchase leading journals individually (at a discount to the cost of acquiring the bundle), effectively slowing the organic revenue growth of academic libraries (**Exhibit 6**).

Exhibit 1
**Back in March 2011, we were seeing ARL member libraries seeing their overall budget cut by about 5% in the two previous years...**




Source: Interviews

Exhibit 2
**...and a majority of the members expecting further cuts**




Source: Interviews

European Media

[1] Please see our 10th March 2011 call *Reed Elsevier: The Inevitable Crunch Point - Downgrading to Underperform Because of Growing Concerns on Elsevier*

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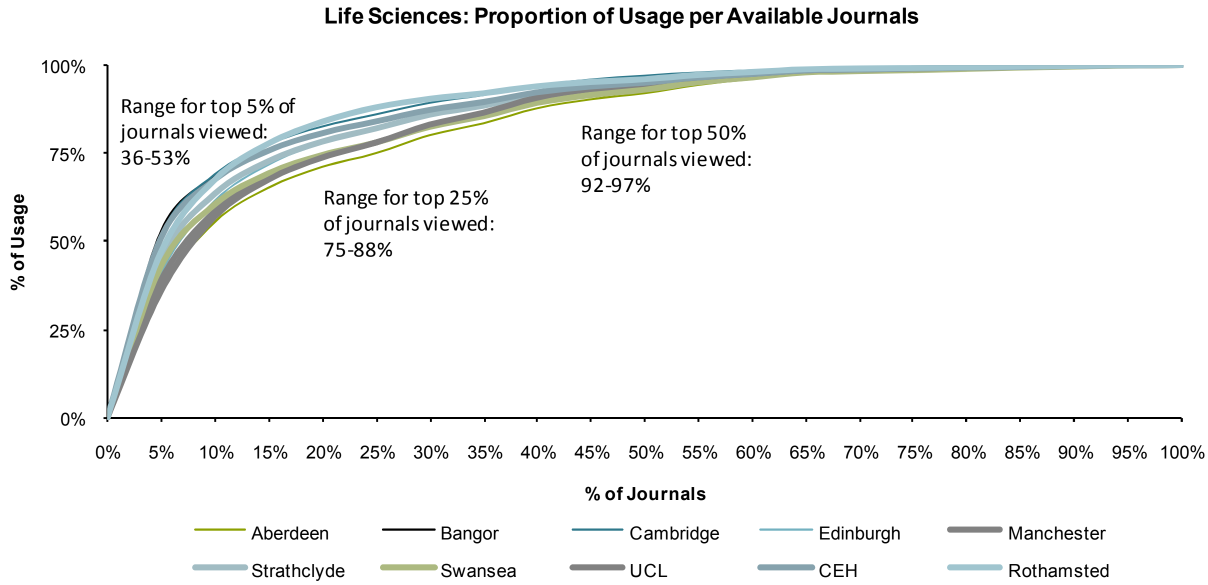
Exhibit 3

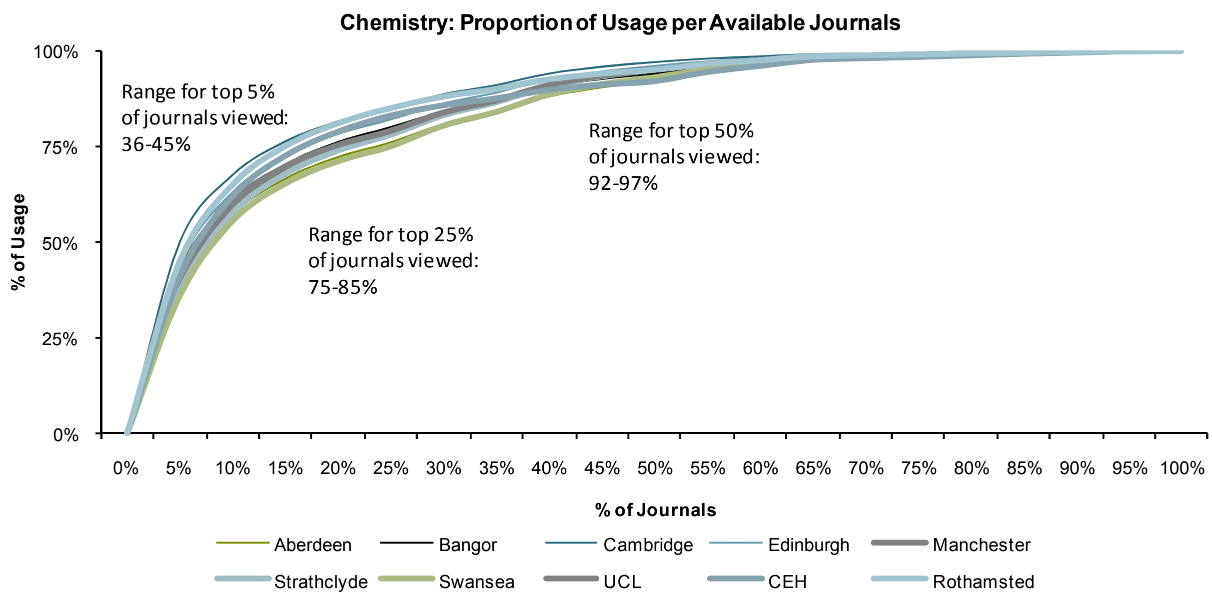
**A low proportion of Life Science journals account for a high proportion of usage at a diverse range of universities in the UK…**




Source: Research Information Network, Bernstein estimates and analysis

Exhibit 4

**…it is a near identical story for Chemistry journals**




Source: Research Information Network, Bernstein estimates and analysis

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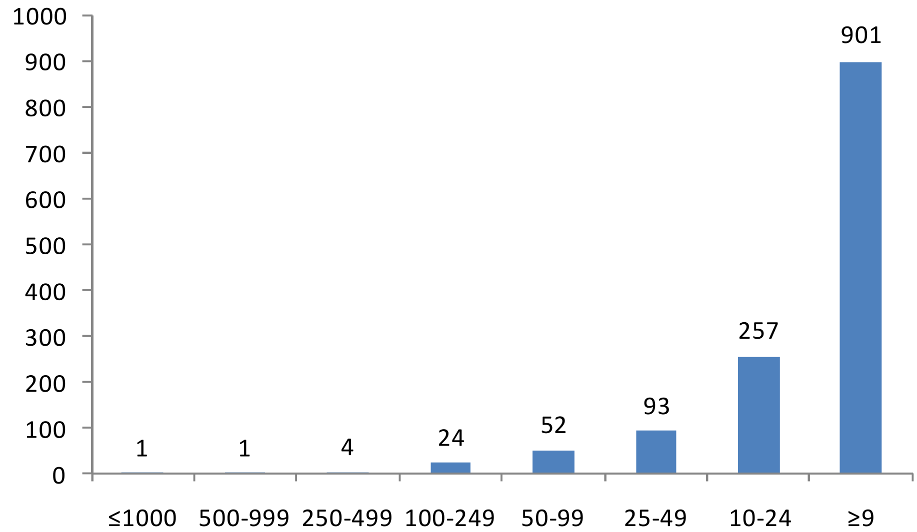
Exhibit 5

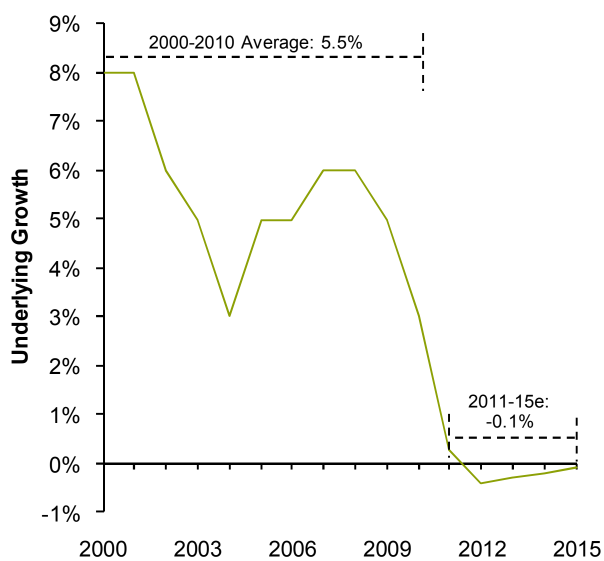
**A similar pattern applies to Elsevier journals, as the data on journals cancelled by NMSU shows: more than two thirds of the Elsevier titles cancelled at the end of 2010 were accessed once a month or less; less than 9% had been accessed once a week or more.**




Source: NMSU Library, Bernstein analysis

Exhibit 6

**In March 2011, we expected Elsevier's Science and Technology business' organic growth in 2011 to be negligible, and then to decline between 2012 and 2015**




Source: Source: Company reports, Bernstein estimates

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### In addition, in 2012 we also thought that political intervention both in Europe and in the UK would force a shift to full Open Access journals, with negative consequences on the economics of Elsevier

In addition to the structural issues we outlined in the previous section, we viewed the flurry of activity related to governmental intervention in favour of Open Access as an indication of the challenges facing the leading subscription publishers[2]. In brief, we argued that a massive shift to Open Access publishing[3], prompted by governments dictating how publicly-funded science should be disseminated, would pose a substantial challenge to the economics of journal publishing and – as a consequence – lower substantially the profitability of Reed Elsevier.

In brief, we calculated the journal revenues and costs of Elsevier under a number of scenarios. To model revenues, we compared the estimated subscription revenues per article (~£3,000, deriving from a little over £1bn in revenues over 310,000 articles published at the time) with the price points of Author Publishing Charges (APCs) prevailing in the marketplace. We then gave Elsevier an extra credit for the revenues potentially accruing from publishing (in a set of new OA journals) all the articles Elsevier receives and rejects every year. We simulated a number of scenarios which took into account optimistic and pessimistic assumptions for the average APCs, and then credited Elsevier with the estimated cost savings accruing from abandoning altogether the subscription model (to calculate these costs, we worked with the finance department of another subscription publisher[4]).

At the time, we concluded that, in a transition to full OA, total costs would decline in the region of 10 to 12% and – even in the most optimistic scenario –the estimated journal Operating Profit could decline between 40% and 90%, depending on the scenarios. As a result, we estimated that the decline in Group Operating Profit could range between -6% and – 22% (**Exhibit 7** and **Exhibit 8**).

Exhibit 7
**In November 2011, we estimated that – by 2015 – a full transition to OA could lower Reed Elsevier's Operating Profit between 6%...**

| | 2015e | |
|---|---|---|
| *Reed Elsevier (£million)* | **Best** | **Base** |
| Elsevier Revenue, £m | 2,191 | 2,191 |
| Est. Legacy Journals, % Elsevier Revenues | 50% | 50% |
| Est. Elsevier Legacy Journals Revenue, £m | 1,095 | 1,095 |
| Elsevier Legacy Journals OPM, % | 40.0% | 40.0% |
| Elsevier Legacy Journals OP, £m | 438 | 438 |
| Elsevier Legacy Journals OPM, % (reduced) | 26.1% | 4.5% |
| Elsevier Legacy Journals OP, £m | 286 | 49 |
| Elsevier "megajournals" additional OP, £m | 53 | 53 |
| Elsevier Legacy + "mergajournals" OP, £m | 339 | 102 |
| Reduction, £m | (99) | (336) |
| Reed Elsevier Group OPM, £m | 1,788 | 1,788 |
| **Reduction, % total** | **(5.6%)** | **(18.8%)** |

Source: Bernstein estimates and analysis

Exhibit 8
**...and 22%**

| | 2015e | |
|---|---|---|
| *Reed Elsevier (£million)* | **Best** | **Base** |
| Elsevier Revenue, £m | 2,191 | 2,191 |
| Est. Journals, % Elsevier Revenues | 50% | 50% |
| Est. Elsevier Journals Revenue, £m | 1,095 | 1,095 |
| Elsevier Journals OPM, % | 40.0% | 40.0% |
| Elsevier Journals OPM, £m | 438 | 438 |
| Elsevier Journals OPM, % (reduced) | 26.1% | 4.5% |
| Elsevier Journals OPM, £m | 286 | 49 |
| Reduction, £m | (152) | (389) |
| Reed Elsevier Group OPM, £m | 1,788 | 1,788 |
| **Reduction, % total** | **(8.5%)** | **(21.7%)** |

Source: Bernstein estimates and analysis

[2] Please see our 10th September 2012 call *Reed Elsevier: A Short History of Two Days in July (and Why Investors Should Care)*
[3] For an extensive background on Open Access, please see our 20th October 2009 call *Professional Publishers: Free at Last? The Future of Open Access in Academic Publishing*
[4] Please see our 26th November 2012 call *Reed Elsevier: Transitioning to Open Access - Are the Cost Savings Sufficient to Protect Margins?*

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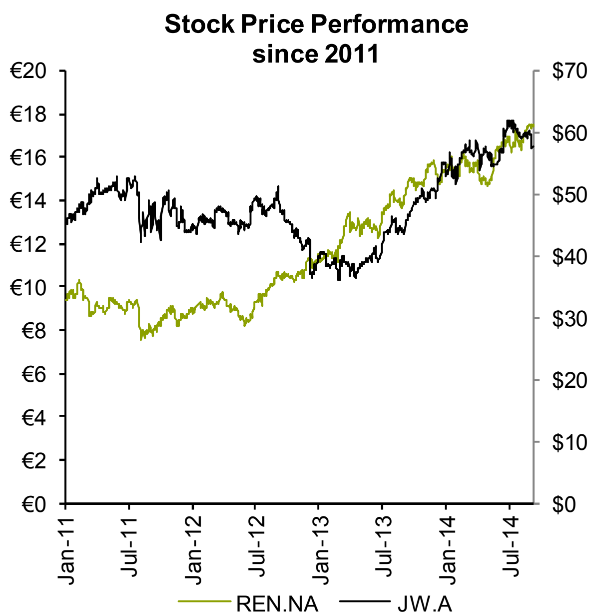
### 11 years after the Berlin Declaration on Open Access, however, the rise of Open Access appears to inflict little or no damage on the leading subscription publishers

#### Subscription publishing appears in good health

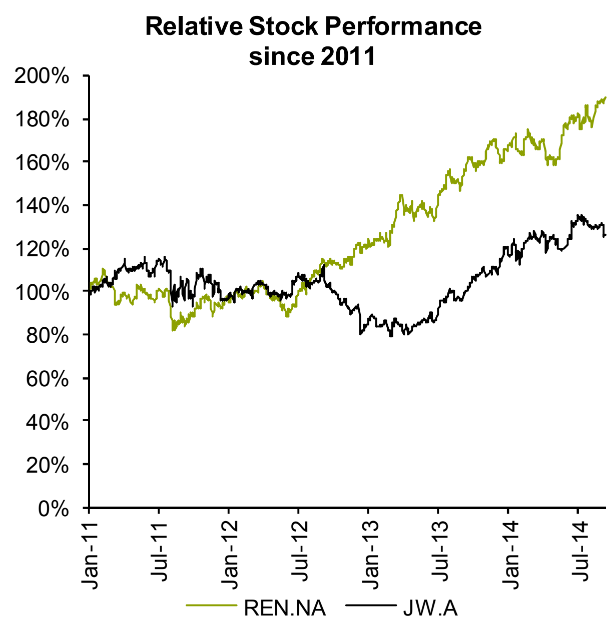
With such dire predictions in mind, we expected Reed Elsevier to perform badly. Instead, the stock had a very good run since 2011, and the performance of Wiley (not covered) – particularly in the past 12 months – mirrors that of Reed Elsevier (**Exhibit 9** and **Exhibit 10**). The most recent earnings announcements suggested that growth is accelerating at Elsevier and that at Wiley renewal rates are very strong (**Exhibit 11** and **Exhibit 12**). Journal revenues at Reed Elsevier are probably growing organically somewhere between 3 and 4% a year, and at around 2% at Wiley. In other words, none of the concerns we formulated in 2011 and 2012 came to pass.

Exhibit 9
**Reed Elsevier and Wiley (to a lesser extent) have done well both in absolute...**




Source: Bloomberg, Bernstein analysis

Exhibit 10
**...and relative terms**




Source: Bloomberg, Bernstein analysis

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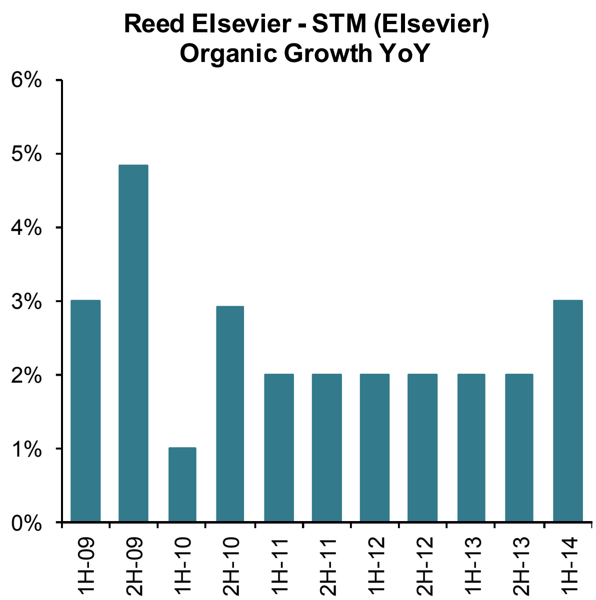
Exhibit 11

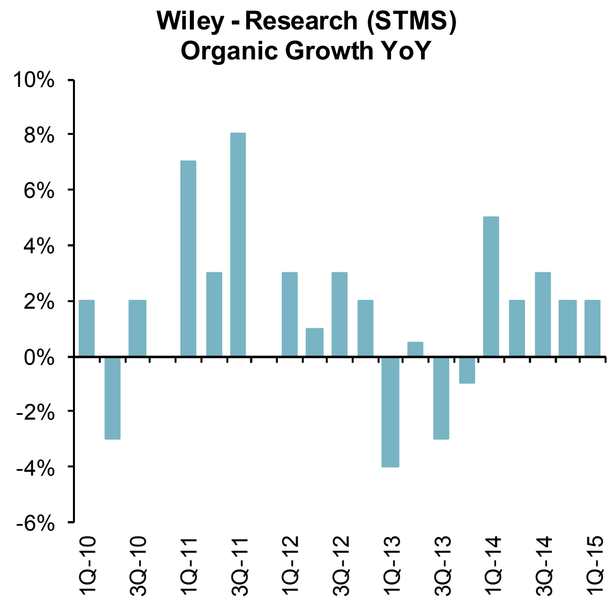
**Elsevier reported faster revenue growth in 1H2014...**




Source: Company reports

Exhibit 12

**,,,while Wiley underlined the strong renewal performance**




Note: Fiscal Year is May-April

Source: Company reports

Why have subscriptions continued to thrive? In part, improving library budgets have helped. As we argued a little over one year ago[5], an improving economy in many parts of the world led to higher than expected academic budgets, which in turn allowed libraries to spend more. We have good data for leading research libraries in North America thanks to the ARL, which periodically surveys its membership. In 2011-12, over half of respondents had faced flat or declining content acquisition budgets, while in 2012-13 the percentage had declined to 36% (**Exhibit 13** and **Exhibit 14**).

[5] Please see our call *Reed Elsevier: Wrong or Early? Why our Concerns about Elsevier Journals Have Not Worked Out (Yet) - A Post Mortem*

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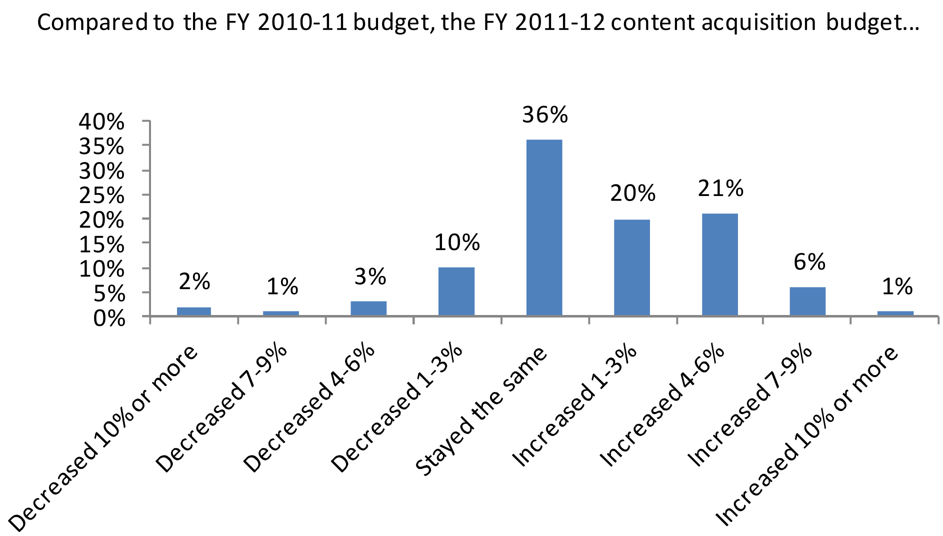
Exhibit 13

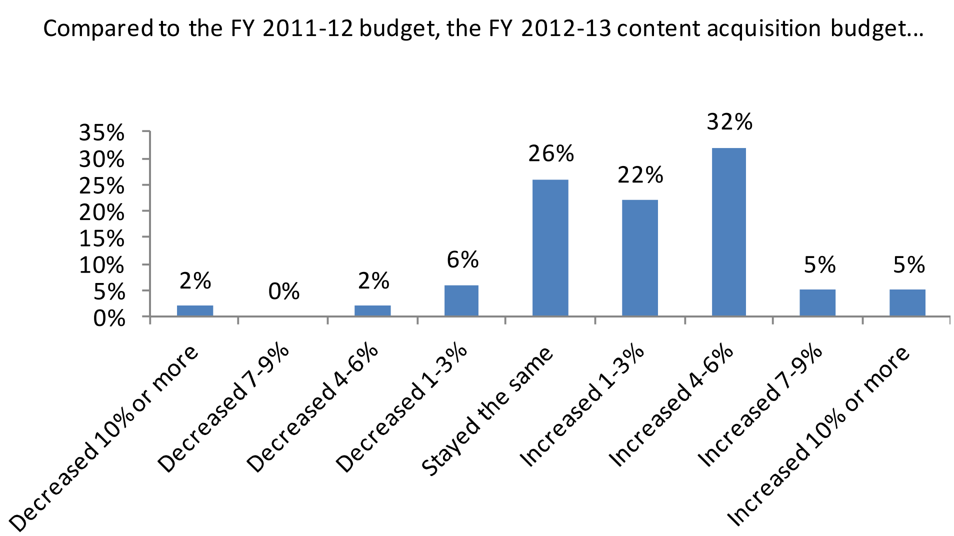
**52% of ARL survey respondents faced flat or declining materials acquisition budgets in 2011-12…**




Source: C. Lowry *ARL Library Budgets after the Great Recession, 2011–13* and Bernstein analysis

Exhibit 14

**…but the percentage declined to 36% in 2012-13**




Source: C. Lowry *ARL Library Budgets after the Great Recession, 2011–13* and Bernstein analysis

At the time (July 2013), we concluded *"With more money available, the libraries facing contract renewals may have felt less compelled to negotiate as hard as they would have if facing flat or declining materials acquisition budgets. While we do not have similar data for other regions, feedback from meetings with* *industry executives paints a picture of similar stabilizing budgets, except for a number of countries in particularly difficult financial conditions".*

### The threat posed by OA seems to recede

The other threat we identified (the rise of OA) also seems to recede. In theory, OA is growing: an estimated 10 to 20% of all STM articles are published in OA, and the number of journals listed in Directory of Open Access Journals (DOAJ) has almost doubled in five years from just above 5,000 to almost 10,000 titles. Perhaps most important, the support of politicians and regulators for OA meant that a conversion of the economic model looked ineluctable. We are increasingly sceptical.

Stepping back to take in the big picture, we would be hard pressed, having spent six years networking extensively in the academic publishing and OA communities, even to articulate what problem is OA trying to accomplish. Ask a librarian, and you will be told that OA is meant to address the serial cost crisis (the rising cost of journal subscriptions and the impact this has on their capacity to fulfil the other missions of academic libraries). Ask a researcher, and you will be told that OA will allow more researchers to read their articles, leading to more citations and – ultimately – to better dissemination of knowledge. Ask an economist, and you will be told that OA will allow small and medium sized companies which do not have access to the latest research to do so, furthering the growth of the economy and job creation. Ask some activists, and you will be told that OA is meant to deflate the margins of capitalist exploitation of public spending. Ask an activist from emerging countries: you will be told that OA is meant to allow researchers and doctors in poor countries to have access to leading research. This lack of clarity on which problem OA is trying to solve, in turn, means that it is difficult to achieve any of these goals.

In addition, OA regulations emerging on the two sides of the Atlantic are very different: the UK (and Europe, to a lesser extent) are firmly supporting Gold OA (including, at least for now, hybrid journals, which lessens the threat for subscription publishers), while the US seems only willing to support a Green OA model with a long enough embargo period (12 months) to discourage any library from abandoning subscriptions. It is difficult to envision why any library would abandon its subscriptions because 25 to 30 per cent of the articles (assuming all government-funded research in the EU is made available on Gold OA) may be available in OA on the day of publication, and another 30% may be available 12 months later in a repository (assuming universal compliance).

### OA funding may in fact be adding to the profits of STM

The hybrid OA model, in fact, may be adding revenues and profits to subscription publishers. Our interviews suggest that the publishers have yet to define exactly how to ensure that they do not "double dip" (an expression describing the practice of pocketing APCs while leaving subscription or bundle pricing unchanged). A practice which some publishers are pursuing at the moment in the UK is to rebate a portion of the OA revenues in the guise of lower subscription charges to libraries in proportion to APCs paid. Whether this practice will prove sufficient to ensure that double dipping does not happen is unclear: unless the entire amount is rebated, the revenues and profits of publishers will be increased anyway. Our interviews suggest that Elsevier has not yet put in place such program. In any case, since, going forward, there is nothing which stops publishers from raising the expected revenues from each account even higher they originally intended to, and then rebating some of the money under the guise of "returning the APC", there is no effective control on double dipping.

Subscription publishers launching OA journals may be double dipping as well. Collections contracts between libraries and publishers, to the best of our knowledge, contain no provisions for how many actual journals or articles will be delivered over what period of time. There is nothing which stops publishers from

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maintaining the subscription pricing trajectory going forward, and then launching separately new OA journals and earning APC revenues on those journals. In this case, all APCs would have to be rebated to every single institution in every country to avoid double dipping. Lack of transparency on the functioning of this model works suggest that it would be very difficult to ensure compliance

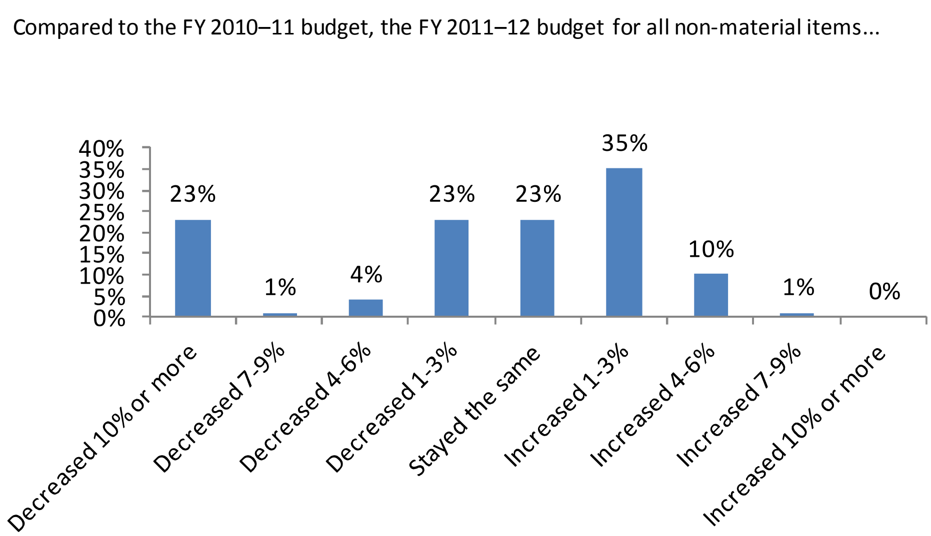
**Not all is well**

Should we then think that Reed Elsevier should visibly outperform the market in the next 12 months based on the rising APCs and the evaporating threat of OA? We do not think so.

We still see two risks which should cause investors to pause. First and foremost, risks to the global economy are not decreasing. Another severe downturn would put additional burdens on governments and – consequently – on the funding of academic and research libraries. When we looked at funding data for ARL libraries in the 2011-13 period, we observed that acquisition budgets grew much faster than non-materials budgets. In other words, librarians protected materials purchases but had less leeway in expanding spending on everything else (**Exhibit 15** and **Exhibit 16**); in addition, only a third of the respondents which completed the ARL survey in both years were able to sustain non-materials spending growth for two years in a row (**Exhibit 17**). We concluded at the time (and still believe) that the spending recovery – even in North America – is fragile and a downturn could rekindle concerns on the sustainability of the model.

Exhibit 15

**In 2011-12, only 11% of ARL respondents increased non-materials budgets above inflation…**




Source: C. Lowry *ARL Library Budgets after the Great Recession, 2011–13* and Bernstein analysis

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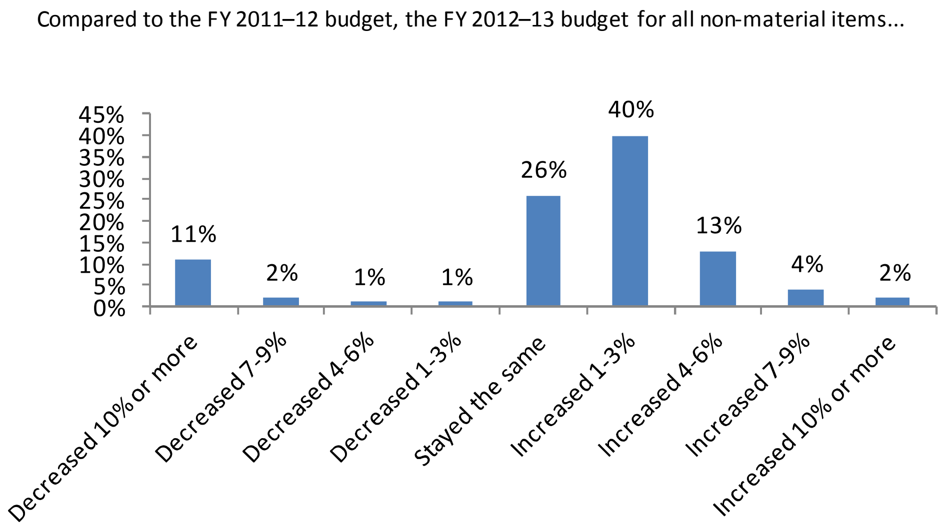
Exhibit 16

**…and that percentage rose only to 19% in 2012-13**




Source: C. Lowry *ARL Library Budgets after the Great Recession, 2011–13* and Bernstein analysis

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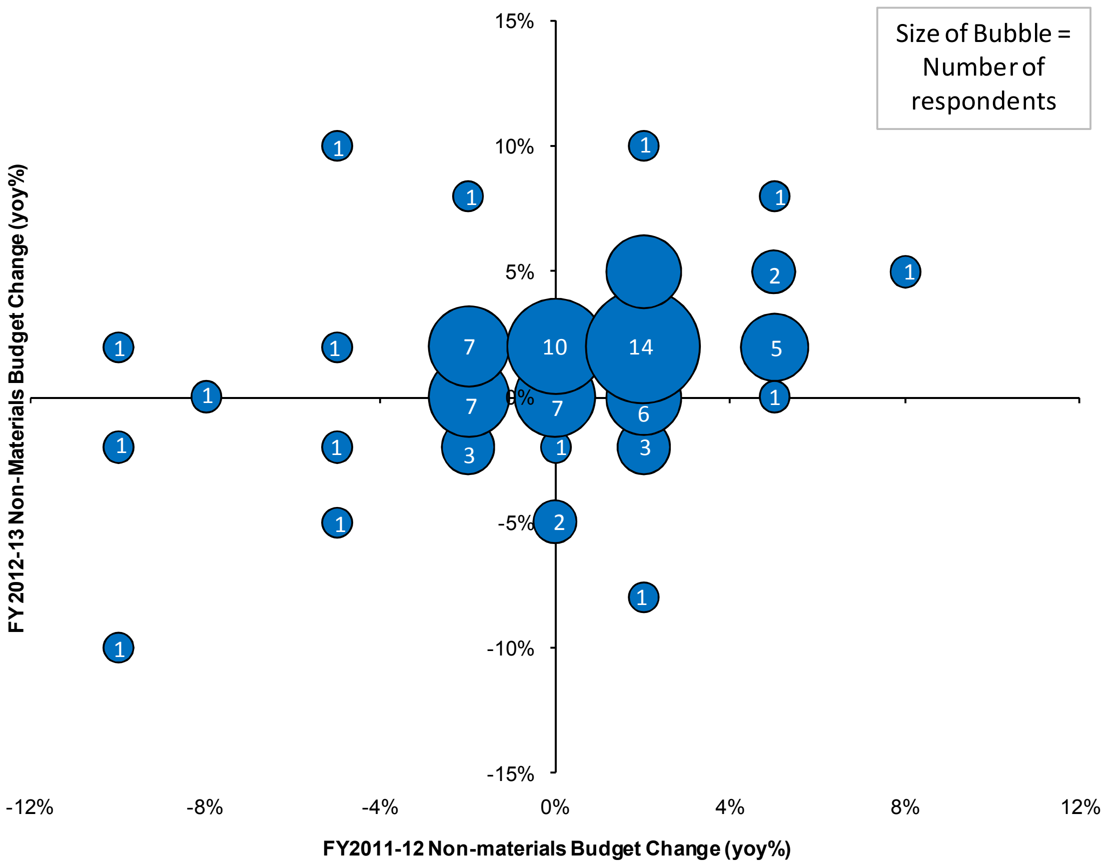
Exhibit 17

**Out of the 88 libraries which answered the survey in both years, only 30 (34% of total respondents) saw increases in their non-materials budget in both years**




Source: C. Lowry *ARL Library Budgets after the Great Recession, 2011–13* and Bernstein analysis

Our second concern is the reputational risk associated with double dipping. As we mentioned earlier, no mechanism is fail safe, since only the publishers are in a position to know what headline growth they expected out of subscription revenues for the years to come and calculate what price increases would achieve that growth. In the absence of transparency, there is nothing to stop publishers from raising prices even further than planned, then rebating APCs and claim they have avoided double dipping.

Ultimately, mixing various sources of taxpayer money heightens the risk that double dipping accusations will be raised. Until now the industry – for the most part – has managed to avoid antagonizing too much politicians and regulators. There have been mistakes (for example, when Elsevier supported at the end of 2011 the now-defunct Research Works Act in the US, triggering both an academic boycott and the distancing of other subscription publishers, like McMillan), but – by and large – the interest of subscription publishers have been taken into account when OA policies have been formalized. The publishers would do well to go out of their way to demonstrate in good faith they have done everything possible to return APCs to the academic world; partial restitutions or – even worse – inaction may still prove pennywise and pound foolish.

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**Recent developments (like the filing for protection from creditors of Swets, a subscription agency) only reinforce the sense that industry forces will help the leading subscription publishers**

The academic publishing community was abuzz earlier this week with the news that Royal Swets & Zeitlinger (Swets), one of effectively only two global subscription agencies, has filed for protection from creditors. Subscription agents were critical to academic publishing in a pre-internet era, when they acted effectively as order takers with academic libraries on behalf of publishers. With electronic distribution and the rise of "Big Deals", the larger publishers have all developed their own direct sales forces, leaving to agents the task of serving primarily smaller publishers and smaller libraries. Agents, effectively, represent the way through which smaller publishers compensate for their lower scale by pooling together their distribution.

Swets (which was acquired in 2007 by Gilde, a Dutch private equity company, for an undisclosed amount) in 2013 saw a significant decline in revenues (-7.7%) , leading to a 95% decline in pre-tax profit. Cash flow from operating activities swung from €10.554 million in 2012 to -€11.928 million in 2013. Management blamed the shift from print to digital of the business, which drives both lower discounts from publishers (effectively lowering the gross margin of the business) and facilitates direct relationships between the larger publishers and academic libraries. If Swets is not rescued, EBSCO Information Services, a US company, stands to effectively remain the only global subscription agent in the academic publishing community, facing only a set of smaller local competitors.

Most large publishers appear to have been aware for weeks and months of the difficulties of Swets, and the time of year (when libraries may be paying for 2015 and beyond, but little or no money has been paid to the publishers) means that – for most publishers – the losses should be modest. Some libraries which have already paid Swets may find themselves having to pay again, and some of them may be hard pressed to find the money, so there could be some revenue loss next year. All of this, clearly, matters little for Elsevier (and even less for Reed Elsevier) in the near term. The size of the possible losses should be minute and irrelevant when compared to the equity value of Reed Elsevier. What is more interesting is what it signals about the state of the business.

As the large publishers go direct (and cherry pick which customers they can take on and which ones they can leave to agents), margins for publishers should rise. Smaller publishers (again, assuming that Swets is not rescued) will likely switch to EBSCO, which should therefore improve its economics but may not have significant incentives to pass on their better economics to their customers or suppliers; in turn, this may spur some smaller publishers to sell or to merge to achieve critical mass to start going directly to more libraries. Ultimately, this looks like another step in the consolidation of the industry across a smaller number of larger publishers, something which benefits Elsevier.

Some of the larger publishers could even be tempted to abandon agency contracts altogether. This move could potentially thin considerably the ranks of agencies by depriving them of considerable revenues at relatively low non-discount cost (the larger publishers recognize much smaller discounts for the agencies – interview suggest as little as 2% vs. as much as 20% for some of the smaller publishers, but on a much larger turnover). This, in turn, could precipitate a rapid consolidation of the publishing industry by forcing smaller publishers to merge, sell or exit. These advantages, however, should be weighed against the political risks associated with depriving smaller academic libraries of access to their publications (because it would not be economical even for the larger publishers to service the smaller libraries) and of the publication of some of the smaller publishers. Antagonizing public colleges in the US, for example, could raise substantial hostility in Congress, since every state has its own flagship schools, and small academic publishers are headquartered in many states. We have no way of knowing today how this play out:

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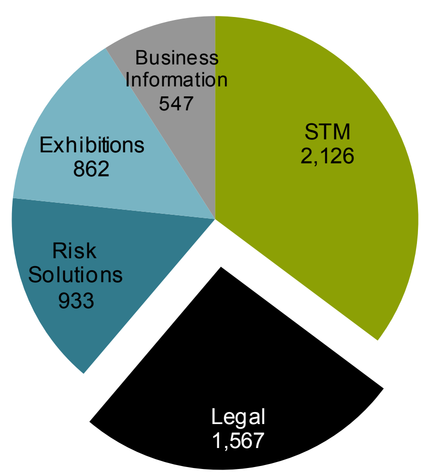
**The rest of the portfolio is either in good health (Risk, Exhibitions – as we have always maintained) or challenged but ultimately too small to matter (Legal)**

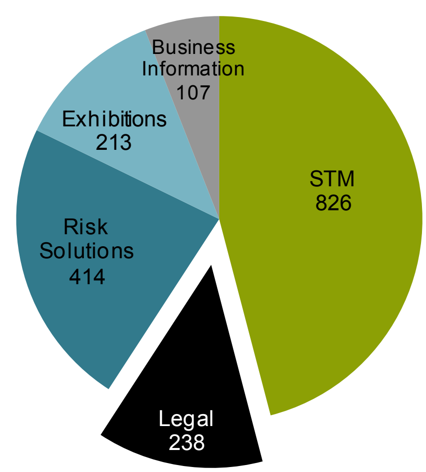
We have written extensively on the Risk, Information and Exhibitions businesses over time, and have indicated explicitly that we like these businesses[6]. We continue to harbour doubts about the outlook for Legal: the combination of a structural decline in large law in the US, combined with the competitive gap with Westlaw, means that LexisNexis will remain a second tier supplier. On the other hand, the retrenching of Bloomberg Law, which looks less likely to pursue aggressively its growth strategy, combined with relatively limited weight of Legal (which in 2013 accounted for 26% of revenues and only 13.6% of the Adjusted Operating Profit - **Exhibit 18** and **Exhibit 19**), and the relatively low expectations of investors for a return to growth means that it is impossible to justify an Underperform rating based on this business alone.

Exhibit 18
**Legal accounts for 26% of revenues...**




Source: Company reports, Bernstein analysis

Exhibit 19
**...and 13.6% of Adj. Operating Profit**




Source: Company reports, Bernstein analysis

**The valuation reflects adequately the current operating performance of the company**

In light of the resilience of Elsevier and no signs of structural deterioration since we made our thesis, we reconsider our valuation of Reed Elsevier. Previously we had used relative valuation discount to MSCI Europe of 20% but now return to a relative valuation premium of 15%, which is in line with the historic averages and where we believe it reflects more adequately the current operating performance of the company (**Exhibits 20** and **21**). This brings us to a target price for Reed Elsevier Plc of £10.00 and for Reed Elsevier NV of €19.00 respectively and we upgrade the stock to Market-perform (from Underperform).

[6] Please see our calls *Reed Elsevier: LexisNexis Risk Solutions - The Part of the Portfolio We Like*, *Reed Elsevier: The Exhibitionists* and *Reed Elsevier: RBI Getting Down to Business* dated 14th January 2013, 10th April 2013 and 26th April 2013 respectively

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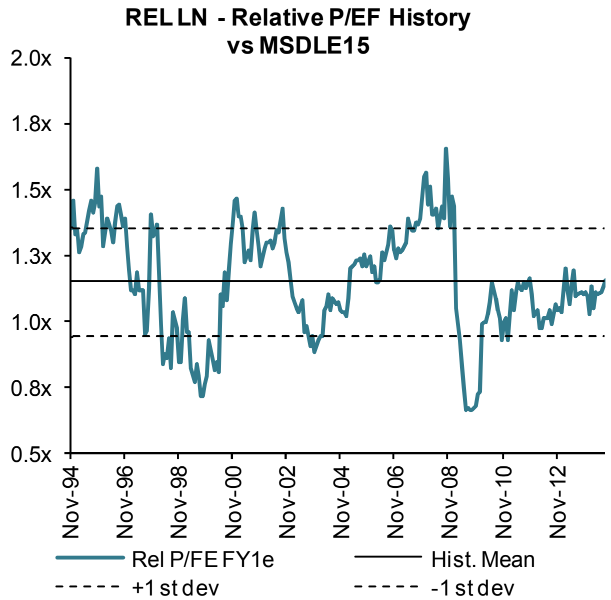
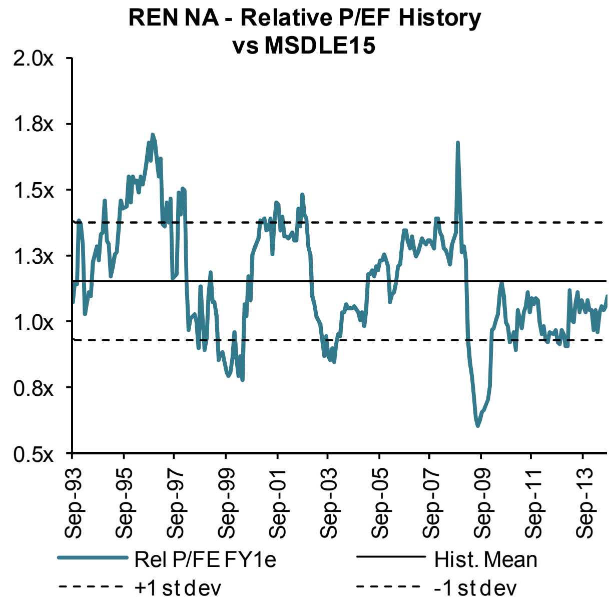
Exhibit 20
**The historical relative multiple for Reed Elsevier Plc against the market is 1.15x...**




Source: Factset, Bernstein analysis

Exhibit 21
**and for Reed Elsevier NV is 1.15x**




Source: Factset, Bernstein analysis

**We continue to prefer Pearson**

Pearson remains our favourite publisher, thanks to its transformational strategy and the opportunity to build a much larger business in the years to come. The cyclical headwinds which have plagued the company for 2.5 years are abating, and 2015 should see substantial EPS growth (we expect it to rise by 14.4% in 2015). With a valuation that is substantially in line with that of Reed Elsevier PLC this year but much faster EPS growth next year (14.4% vs. 6.8% for REL.LN) Pearson looks much more attractive.

*European Media*

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### Changes to our estimates

We have updated for changes to currency rates as well as adjust the revenues for STM segment.

As a result, our new EPS estimates for Reed Elsevier Plc are as follows: 54.9GBp in 2014 (formerly 56.3GBp); 58.6GBp in 2015 (formerly 59.8GBp); and 61.4 GBp in 2016 (formerly 62.6 GBp); for Reed Elsevier NV: €1.04 in 2014 (formerly €1.07); €1.14 in 2015 (formerly €1.15); €1.20 in 2016 (formerly €1.20)

Exhibit 22
**Reed Elsevier – Changes to our estimates**

| | Old | | | New | | | %Δ | | |
|---|---|---|---|---|---|---|---|---|---|
| | FY2014E | FY2015E | FY2016E | FY2014E | FY2015E | FY2016E | FY2014E | FY2015E | FY2016E |
| **Revenues** | | | | | | | | | |
| **Total** | **5,825** | **5,950** | **6,078** | **5,682** | **5,831** | **5,965** | **-2.4%** | **-2.0%** | **-1.9%** |
| Scientific, Technology & Medical | 2098 | 2140 | 2182 | 2050 | 2104 | 2146 | -2.3% | -1.7% | -1.7% |
| Risk Solutions & Business Information | 1434 | 1481 | 1511 | 1406 | 1475 | 1515 | -2.0% | -0.4% | 0.2% |
| Risk Solutions | 949 | 997 | 1027 | 932 | 994 | 1024 | -1.8% | -0.3% | -0.3% |
| Business Information | 484 | 484 | 484 | 474 | 481 | 491 | -2.2% | -0.6% | 1.3% |
| Legal | 1406 | 1406 | 1406 | 1370 | 1378 | 1378 | -2.5% | -2.0% | -2.0% |
| Exhibitions | 888 | 924 | 979 | 856 | 874 | 926 | -3.6% | -5.4% | -5.4% |
| **Adj. Operating Profit - Continuing** | **1749** | **1805** | **1849** | **1,708** | **1,773** | **1,818** | **-2.4%** | **-1.8%** | **-1.7%** |
| **Adj. Op. Profit %margin** | **30.0%** | **30.3%** | **30.4%** | **30.0%** | **30.4%** | **30.5%** | **3bps** | **7bps** | **6bps** |
| Scientific, Technology & Medical | 792 | 812 | 833 | 774 | 798 | 819 | -2.3% | -1.7% | -1.7% |
| Risk Solutions & Business Information | 509 | 533 | 548 | 499 | 531 | 548 | -1.9% | -0.4% | 0.0% |
| Risk Solutions | 407 | 429 | 444 | 400 | 428 | 443 | -1.8% | -0.3% | -0.3% |
| Business Information | 102 | 104 | 246 | 99 | 103 | 241 | -2.2% | -0.6% | -2.0% |
| Legal | 239 | 246 | 246 | 233 | 241 | 241 | -2.5% | -2.0% | -2.0% |
| Exhibitions | 218 | 222 | 230 | 210 | 210 | 218 | -3.6% | -5.4% | -5.4% |
| **Adj. profit before tax** | **1,594** | **1,663** | **1,723** | **1,553** | **1,631** | **1,692** | -2.6% | -2.0% | -1.8% |
| **Adjusted net income (total)** | **1,214** | **1,267** | **1,313** | **1,182** | **1,242** | **1,289** | -2.6% | -2.0% | -1.8% |
| **Adjusted EPS (GBP)** | **56.3** | **59.8** | **62.6** | **54.9** | **58.6** | **61.4** | **-2.6%** | **-2.0%** | **-1.8%** |
| **Adjusted EPS (€)** | **1.07** | **1.15** | **1.20** | **1.04** | **1.14** | **1.20** | **-2.3%** | **-0.7%** | **-0.6%** |
| **Organic Growth** | | | | | | | | | |
| **Group** | **3.3%** | **2.3%** | **2.3%** | **3.3%** | **2.7%** | **2.3%** | **0bps** | **36bps** | **-2bps** |
| Scientific, Technology & Medical | 2.5% | 2.0% | 2.0% | 2.5% | 3.0% | 2.0% | 0bps | 100bps | 0bps |
| Risk Solutions & Business Information | *5.3%* | *4.0%* | *2.7%* | 5.3% | 4.0% | 2.7% | 0bps | 0bps | 0bps |
| Risk Solutions | 6.0% | 5.0% | 3.0% | 6.0% | 5.0% | 3.0% | 0bps | 0bps | 0bps |
| Business Information | 4.0% | 2.0% | 2.0% | 4.0% | 2.0% | 2.0% | 0bps | 0bps | 0bps |
| Legal | 1.0% | 0.0% | 0.0% | 1.0% | 0.0% | 0.0% | 0bps | 0bps | 0bps |
| Exhibitions | 6.0% | 4.0% | 6.0% | 6.0% | 4.0% | 6.0% | 0bps | 0bps | 0bps |

Source: Company reports, Bernstein estimates and analysis

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## Appendix - Financial Forecasts

Exhibit 23

**Income Statement – Reed Elsevier**

| REED ELSEVIER £ million | 2010 | 2011 | 2012 | 2013 | 2014E | 2015E | 2016E | 2013-16 CAGR |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | **6,055** | **6,002** | **6,116** | **6,035** | **5,682** | **5,831** | **5,965** | **-0.4%** |
| Operating costs (before goodwill and exc) | (4,492) | (4,366) | (4,381) | (4,237) | (3,967) | (4,050) | (4,139) | -0.8% |
| Corporate costs | (34) | (44) | (47) | (49) | (8) | (8) | (8) | |
| Unallocated pension credit | 26 | 34 | 25 | | | | | |
| **Adjusted operating profit** | **1,555** | **1,626** | **1,713** | **1,749** | **1,708** | **1,773** | **1,818** | **1.3%** |
| Adj Net Finance Costs | (276) | (235) | (216) | (177) | (155) | (142) | (126) | -10.7% |
| Adj Profit Before Tax | 1,279 | 1,391 | 1,497 | 1,572 | 1,553 | 1,631 | 1,692 | 2.5% |
| Adj Tax | (290) | (324) | (354) | (370) | (365) | (384) | (398) | 2.5% |
| Minority Interests | (6) | (7) | (5) | (5) | (5) | (5) | (5) | |
| Adjusted net income | 983 | 1,060 | 1,138 | 1,197 | 1,182 | 1,242 | 1,289 | 2.5% |
| **Adjusted net income (Cont ops)** | **983** | **1,060** | **1,138** | **1,197** | **1,182** | **1,242** | **1,289** | **2.5%** |
| | | | | | | | | |
| **Adjusted EPS (basic)** | | | | | | | | |
| PLC (£) | 0.4340 | 0.4670 | 0.5010 | 0.5400 | 0.5487 | 0.5865 | 0.6145 | 4.4% |
| NV (€) | 0.78 | 0.83 | 0.95 | 0.99 | 1.04 | 1.14 | 1.20 | 6.5% |
| | | | | | | | | |
| *Revenue growth YoY* | *-0.3%* | *-0.9%* | *1.9%* | *-1.3%* | *-5.8%* | *2.6%* | *2.3%* | |
| *Adjusted operating margin* | *25.7%* | *27.1%* | *28.0%* | *29.0%* | *30.0%* | *30.4%* | *30.5%* | |

| REED ELSEVIER £ million | 2010 | 2011 | 2012 | 2013 | 2014E | 2015E | 2016E | 2013-16 CAGR |
|---|---|---|---|---|---|---|---|---|
| **Revenue** | **6,055** | **6,002** | **6,116** | **6,035** | **5,682** | **5,831** | **5,965** | **-0.4%** |
| Scientific, Technical & Medical | 2,026 | 2,058 | 2,063 | 2,126 | 2,050 | 2,104 | 2,146 | 0.3% |
| Risk Solutions & Business Information | 718 | 1,603 | 1,589 | 1,480 | 1,406 | 1,475 | 1,515 | 0.8% |
| o/w Risk Solutions | | 908 | 926 | 933 | 932 | 994 | 1,024 | 3.1% |
| o/w Business Information | 718 | 695 | 663 | 547 | 474 | 481 | 491 | -3.5% |
| Legal | 2,618 | 1,634 | 1,610 | 1,567 | 1,370 | 1,378 | 1,378 | -4.2% |
| Exhibitions | 693 | 707 | 854 | 862 | 856 | 874 | 926 | 2.4% |
| | | | | | | | | |
| **Adjusted Operating Profit (divisions only)** | **1,563** | **1,636** | **1,735** | **1,798** | **1,716** | **1,781** | **1,826** | **0.5%** |
| Scientific, Technical & Medical | 724 | 768 | 780 | 826 | 774 | 798 | 819 | -0.3% |
| Risk Solutions & Business Information | 89 | 472 | 511 | 521 | 499 | 531 | 548 | 1.7% |
| o/w Risk Solutions | | 362 | 392 | 414 | 400 | 428 | 443 | 2.3% |
| o/w Business Information | 89 | 110 | 119 | 107 | 99 | 103 | 105 | -0.5% |
| Legal | 592 | 229 | 234 | 238 | 233 | 241 | 241 | 0.4% |
| Exhibitions | 158 | 167 | 210 | 213 | 210 | 210 | 218 | 0.7% |
| | | | | | | | | |
| **Adjusted Operating Profit margin** | **25.8%** | **27.3%** | **28.4%** | **29.8%** | **30.2%** | **30.5%** | **30.6%** | |
| Scientific, Technical & Medical | 36% | 37% | 38% | 39% | 38% | 38% | 38% | |
| Risk Solutions & Business Information | 12% | 29% | 32% | 35% | 35% | 36% | 36% | |
| o/w Risk Solutions | | 40% | 42% | 44% | 43% | 43% | 43% | |
| o/w Business Information | 12% | 16% | 18% | 20% | 21% | 21% | 21% | |
| Legal | 23% | 14% | 15% | 15% | 17% | 17% | 17% | |
| Exhibitions | 23% | 24% | 25% | 25% | 25% | 24% | 24% | |
| | | | | | | | | |
| **Organic Revenue Growth** | **1.6%** | **1.9%** | **3.9%** | **2.9%** | **3.3%** | **2.7%** | **2.3%** | |
| Scientific, Technical & Medical | 2.0% | 2.0% | 2.0% | 2.0% | 2.5% | 3.0% | 2.0% | |
| Risk Solutions & Business Information | -2.0% | 2.7% | 4.3% | 6.3% | 5.3% | 4.0% | 2.7% | |
| o/w Risk Solutions | | 4.0% | 6.0% | 8.0% | 6.0% | 5.0% | 3.0% | |
| o/w Business Information | -2.0% | 1.0% | 2.0% | 4.0% | 4.0% | 2.0% | 2.0% | |
| Legal | 1.0% | 2.1% | 1.0% | 1.0% | 1.0% | 0.0% | 0.0% | |
| Exhibitions | 8.0% | 0.0% | 15.0% | 2.0% | 6.0% | 4.0% | 6.0% | |

Source: Company reports, Bernstein estimates and analysis

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**Disclosure Appendix**

## Valuation Methodology

### Reed Elsevier and Pearson

We base our target prices for Reed Elsevier and Pearson on a price-to-earnings methodology. In order to calculate our target prices, we look at the company's current relative multiple (company price to earnings ratio (P/E) relative to MSCI Europe and then apply a target relative multiple given the company's future EPS growth prospects to 2016. We believe that the period between 2013 and 2016 represents a valid timeframe to assess EPS growth prospects.

Exhibit 24
**Valuation – Reed Elsevier**

| Company | Rating | Currency | Market Cap | 23-Sep-14 Price | EPS CAGR 2013-16E | 2014E EPS | 2014E P/E | Relative P/E Multiple | Target Relative P/E Multiple | Target Price | Implied % Up / Downside |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Pearson | O | GBP | £9,807 | 1,214.0p | 5.7% | 65.4p | 18.6x | 121% | 130% | 1300p | 7% |
| Reed Elsevier PLC | M | GBP | £6,996 | 989.5p | 4.4% | 54.9p | 18.0x | 117% | 115% | 1000p | 1% |
| Reed Elsevier NV | M | EUR | € 20,974 | € 17.75 | 6.5% | € 1.04 | 17.0x | 111% | 115% | € 19.00 | 7% |
| **MSCI Europe** | | | | | **9-11%** | | **15.3x** | | | | |

Source: Company reports, Bloomberg, Bernstein estimates and analysis

## Risks

### Reed Elsevier

The following are notable risks to our Market-perform rating:

- The key risk to our Underperform rating and 12-month target prices for Reed Elsevier derive primarily from the impact of the economic cycle and from M&A activity. Also:
- While most of the revenues should be relatively stable irrespective of changes in economic activity, some segments (RX, RBI) are more sensitive than others;
- A divestiture of significant parts of the portfolio (e.g., Exhibitions) would probably trigger a re-rating;
- While market shares are relatively stable, fluctuations deriving from failure to win individual contracts or clients can negatively or positively affect revenues;
- In addition, Reed Elsevier is highly exposed to currency fluctuations: approximately 55% of its revenue is denominated in U.S. dollars.

### Pearson

The following are notable risks to our Outperform rating:

- We believe that the key risk to our thesis and to our 12 month target price for Pearson derives primarily from the impact of the economic cycle;
- While most of the revenues should be relatively stable irrespective of changes in economic activity, the FT Group (in particular, the FT newspaper) is more sensitive to the cycle, and none of the businesses is fully insulated from a deep and lasting slow down of economic activity;
- Business specific risks include any major loss of contracts in professional assessment and testing; failure to win adoption for textbook programs in any major US state; a prolonged period of failure for Penguin to publish books that become best-sellers;

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- In addition to the economic cycle risks mentioned above, Pearson is highly exposed to currency fluctuations: approximately 60% of its revenue is denominated in US dollars.

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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 09/23/2014, Bernstein's ratings were distributed as follows: Outperform - 44.5% (1.9% banking clients) ; Market-Perform - 44.2% (0.8% banking clients); Underperform - 11.3% (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.
- Helen Luong maintains a long position in Yahoo! Inc (YHOO).

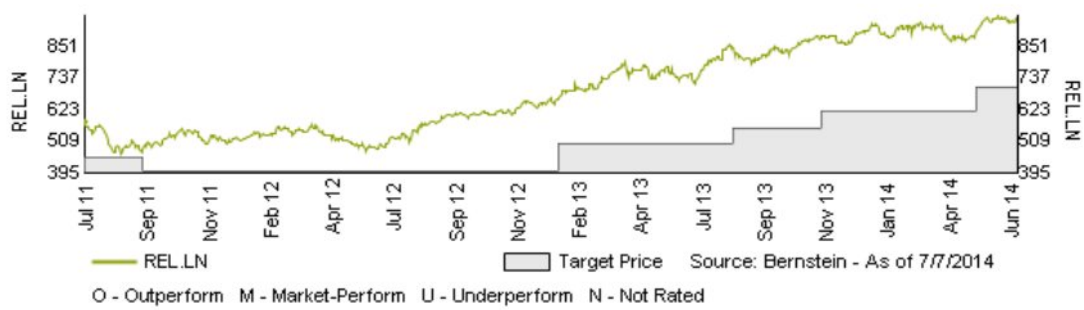
**12-Month Rating History as of 09/22/2014**

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

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

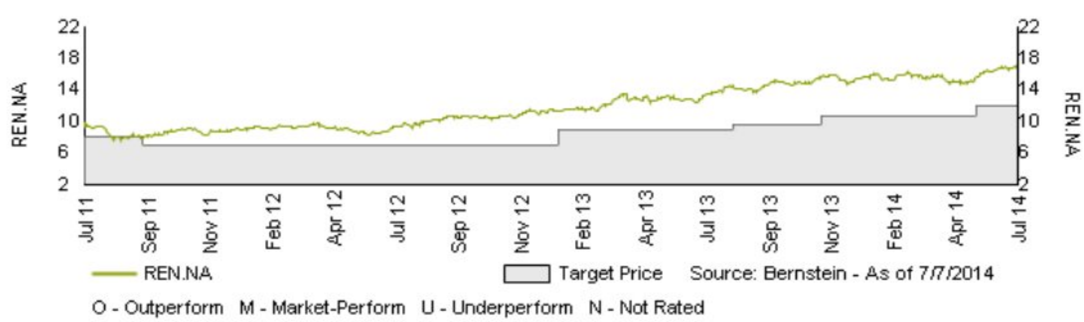
**REL.LN / Reed Elsevier PLC**

| Date | Rating | Target(GBp) |
|---|---|---|
| 06/30/11 | U | 450.00 |
| 09/14/11 | U | 400.00 |
| 01/14/13 | U | 500.00 |
| 08/08/13 | U | 550.00 |
| 11/20/13 | U | 615.00 |
| 05/20/14 | U | 700.00 |




**REN.NA / Reed Elsevier NV**

| Date | Rating | Target(EUR) |
|---|---|---|
| 06/30/11 | U | 8.00 |
| 09/14/11 | U | 7.00 |
| 01/14/13 | U | 8.75 |
| 08/08/13 | U | 9.50 |
| 11/20/13 | U | 10.50 |
| 05/20/14 | U | 12.00 |



**PSON.LN / Pearson PLC**

| Date | Rating | Target(GBp) |
|---|---|---|
| 06/23/11 | O | 1275.00 |
| 02/28/12 | O | 1400.00 |
| 03/14/14 | O | 1300.00 |


## OTHER DISCLOSURES

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