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Reed Elsevier: The Other 99% Wins One - Elsevier Withdraws Support for the RWA

Ticker	Rating	CUR	27 Feb 2012 Closing Price	Target Price	TTM Rel. Perf.	EPS 2011A	EPS 2012E	EPS 2013E	P/E 2011A	P/E 2012E	P/E 2013E	Yield
REL.LN	U	GBp	552.00	400.00	7.6%	46.70	47.10	48.20	11.8	11.7	11.5	4.3%
REN.NA	U	EUR	9.29	7.00	5.1%	0.83	0.83	0.85	11.2	11.2	10.9	4.7%
MSDLE15			1110.49			94.29	102.83	114.38	11.8	10.8	9.7	4.2%

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

Highlights

Less than two months ago, academics in the mathematics community started a boycott of Elsevier, citing grievances with the business model of the company and objecting to its support for SOPA and the RWA (for more details, please see our 6th February call ***Occupy Elsevier****).*

- **Elsevier announced on the 27th February it is withdrawing its support for the Research Works Act, the immediate trigger of the recent academic boycott.** In a letter to the mathematics community, Elsevier announced on the 27th February it is withdrawing its support for the Research Works Act (RWA). Support for the RWA (proposed legislation aimed at prohibiting "Public Access" mandates for the Federal Government) was cited by British mathematician Tim Gowers, as one of his three reasons to boycott Elsevier going forward, in the announcement which started the boycott. At the same time, Representatives Issa (R-CA) and Maloney (D-NY) announced they are backing away from the act itself.

- **This is the right decision in our view, and we commend Reed Elsevier for avoiding stubbornly supporting a self-defeating course of action; whether this will be enough to stave off worse consequences remains to be seen.** We argued that Elsevier could and should withdraw its support for the RWA. It was in fact clear to us that the bill had little or no chance to pass, and that support for it was only stoking resentment. In this sense, we think the management of Reed Elsevier showed sound common sense in withdrawing support – although action could and should have been taken sooner. Elsevier will now hope that the boycott tapers off, but this outcome is by no means certain. The greatest risk to the business is posed by the academic community targeting membership of editorial boards and convincing them to resign: a significant number of defections could paralyze journals, threatening the sustainability of Elsevier's portfolio of publications.

- **Investors still have a right to be confused on what level of threat looms on the business.** In the past, the management of Reed Elsevier told investors that "Public Mandates" were not a threat to the business. The company then decided to support prohibition, and now it argues that it still opposes mandates, but does not support legislation that prohibits them. We think the risk is lower than Elsevier seems to believe, and that the boycott may end posing much greater risks than Federal Government Public Mandates ever posed.

- **Consensus is still treating Elsevier's problems as cyclical, in spite of the rising evidence the issues are deeper.** Sell side consensus for Elsevier (as well as for LexisNexis) continues to treat the slower organic revenue growth as cyclical, and continues to push back the recovery by 12 months. We think that the boycott, regardless of how it ends, shows that the issues are deeper. Elsevier's decision to back off

European Media

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from its support of the RWA after just 7,500 signatures were collected provides further validation of our concerns.

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 a pattern that has continued in 2011. 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 we think 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 £4.00/€7.00 for its UK and Dutch stocks, respectively.

Details

Elsevier announced it is withdrawing its support for the Research Works Act, the immediate trigger of the recent academic boycott

In a letter to the mathematics community, Elsevier announced on the 27th February it is withdrawing its support for the Research Works Act (RWA)[1]. Support for the RWA (proposed legislation aimed at prohibiting "Public Access" mandates for the Federal Government) was cited by Tim Gowers, a British mathematician, as one of his three reasons to boycott Elsevier going forward. The full text of the announcement[2] suggests that Elsevier will continue to fight "Public Access" mandates, but does not say how they intend to do so going forward. At the same time, Representatives Issa (R-CA) and Maloney (D-NY) announced they are effectively backing away from the act itself[3].

We commend Reed Elsevier for avoiding stubbornly supporting a self-defeating course of action; whether this will be enough to stave off worse consequences remains to be seen

In our ***Occupy Elsevier*** call, we argued that Elsevier could and should withdraw its support for the RWA. It was in fact clear that outspoken opposition from segments of the academic community could only mean that the bill had little or no chance to pass, and that support for it was only stoking resentment. In this sense, we think the management of Reed Elsevier showed sound common sense in withdrawing support – although action could and should have been taken sooner.

As of the evening of the 27th February, over 7,500 academics had signed the online pledge to boycott Elsevier. As we pointed out in our call, the outlook for the boycott is still uncertain. On the one hand, withdrawing support for the RWA may lead some segments of the academic community to believe that the primary goal has been achieved, and deflate momentum. On the other hand, academics may conclude that

[1] http://www.elsevier.com/wps/find/P11.cws_home/lettertothecommunity
[2] http://www.elsevier.com/wps/find/intro.cws_home/newmessagerwa
[3] http://www.nytimes.com/2012/02/28/science/a-wide-gulf-on-open-access-to-federally-financed-research.html?pagewanted=all

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the company is vulnerable to the boycott, and redouble efforts to win concessions on their other two grievances (the alleged high prices of journals and the structure of journals bundling). Management of Elsevier will be scrutinizing pledge numbers in the coming days and weeks, hoping the clamour subsides.

Ultimately, we still believe the key to the success of the boycott will be largely driven by the behaviour of academics regarding editorial boards. Monitoring over the coming years the participation of signatories to the boycott will be difficult, and the impact of withdrawing articles and peer review work unlikely to make any significant difference. A wave of resignations from editorial boards, on the other hand, could seriously disrupt the activity of Elsevier journals and – in extreme cases – lead them to fold if replacement of adequate calibre could not be found.

In this respect, we think that the academic community is likely to become "smarter" than it has been in the past. Some academics have started to understand that Elsevier may be more vulnerable in the stock market than in its relations with academic libraries. This may well lead academics (and academic librarians) to push for more, targeting aggressively academics who sit on editorial boards. Elsevier can try to hold on to them (after all, there are all sorts of perks available for the members of editorial boards), but this can – in turn – become an even greater issue if the academic community decides that monetary compensation and T&E create an untenable conflict of interest.

Unfortunately, Elsevier is running out of structural options. There is little or nothing management can do to address the grievances about prices and contract structure (other than lowering its prices, which we obviously do not expect the company to offer until it has no other course of action left). So we expect no more substantial changes unless the boycott starts to seriously disrupt the publication of some of its flagship journals.

Investors still have a right to be confused on what level of threat looms on the business

In the past, the management of Reed Elsevier told investors that "Public Mandates" were not a threat to the business. The company then decided to support prohibition, and now it argues that it still opposes mandates, but does not support legislation that prohibits them. Investors are entitled to be confused on what level of threat "Public Mandates" pose to the business.

US research accounts for about 30% of all science articles published in the world. The latest National Science Foundation data is relatively aged (the latest available data is for 2008), but the changes in spending are likely to be minor. According to the NSF, the Federal Government funds about 60% of all research (**Exhibit 1**), but the articles which explicitly acknowledge Federal funding are about one third of that (22% of total articles published by US researchers). Even correcting for the higher "impact factor" (a proxy for the relevance of research) of US articles (estimated to be about 50% higher than the average impact of all articles published around the world), we doubt that a policy that mandates "Public Dissemination" of about 15% of all research published (averaging out the conflicting 60% and the 22%) would change purchase patterns among core academic libraries.

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Exhibit 1

The Federal Government funds more than 60% of all US R&D spending

	2003	2004	2005	2006	2007	2008
Federal government	61.8%	63.9%	63.8%	63.1%	61.5%	60.2%
Institutional funds	19.1%	17.9%	18.0%	19.0%	19.7%	20.1%
State and local government	6.6%	6.7%	6.4%	6.2%	6.3%	6.6%
Industry	5.4%	4.9%	5.0%	5.0%	5.4%	5.5%
Other	7.1%	6.6%	6.8%	6.7%	7.1%	7.6%

Source: National Science Foundation, Bernstein analysis

So why support the RWA? We suspect that Elsevier decided that the risk of Public Dissemination mandates could upset the relationship with marginal customers, as well as open the door to more aggressive legislation in the future that further restricted the role of subscription publishers warranted this course of action[4]. In this sense, the RWA looked like a safe course to protect the business from a set of future unknown changes that could only carry downside with them. Supporting it, at the time, must have looked perfectly sensible, even if we know it was poor judgment and, most likely, the consequence of the disconnect between management and large groups of academics and academic librarians who harbour deep resentment towards the company.

Consensus is still treating Elsevier's problems as cyclical, in spite of the rising evidence the issues are deeper

Sell side consensus for Elsevier (as well as for LexisNexis) continues to treat the slower organic revenue growth as cyclical, and continues to push back by 12 months the recovery (**Exhibit 2**).

Exhibit 2

The sell side seems to be pushing back Elsevier's (and LexisNexis') supposed "return to mid-single-digit growth" by one more year, every year

4Q10 Cons.	FY11e	FY12e	4Q11 Cons.	FY12e	FY13e
Reed Elsevier					
Elsevier	2.2%	**3.3%**	Elsevier	**2.9%**	**3.2%**
LexisNexis	2.0%	**3.5%**	LexisNexis	**2.6%**	**3.8%**
Exhibitions	(1.0%)	7.4%	Exhibitions	13.3%	(1.3%)
RBI	(3.9%)	1.1%	RBI	4.8%	1.7%
Group	**1.1%**	**3.2%**	**Group**	**4.4%**	**2.4%**

Source: Inquiry Financial, Bernstein estimates and analysis

Note: Consensus expectations for reported growth assumed to be = organic growth expectations for outer years (for the second unreported year, at the time the consensus poll was taken, onwards); e.g, FY11e as per pre-FY10 consensus poll by Inquiry Financial

We think that the boycott, regardless of how it ends, shows that the issues are deeper. Elsevier's decision to back off from its support of the RWA after just 7,500 signatures were collected provides further validation of our concerns.

[4] For a more complete analysis of Public Mandates, please see our call 11th March 2010 call ***Reed Elsevier: How the Obama Administration May Affect the Future of Science, Technical & Medical (STM) Publishing***

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Disclosure Appendix

Valuation Methodology

Professional Publishers

For the Professional Publishers, we base our target price on a price to earnings methodology. In order to calculate our target prices, we look at each company's current relative multiple (company price to earnings ratio, P/E, relative to MSCI Europe P/E) and then apply a target relative multiple given each company's future EPS growth prospects to 2014 (**Exhibit 3**). We believe that the period between 2011 and 2014 represents a valid timeframe to assess the EPS growth prospects to 2014.

Exhibit 3
Valuation Methodology – Reed Elsevier

Company	Rating	Currency	Market Cap	27-Feb-12 Price	EPS CAGR 2011-14E	2012E EPS	2012E P/E	Relative P/E Multiple	Target Relative P/E Multiple	Target Price	% Upside Downside
Reed Elsevier PLC	U	GBP	£6,607	552.0p	3.0%	47.1p	11.7x	108%	90%	400p	-28%
Reed Elsevier NV	U	EUR	€ 6,791	€ 9.29	2.8%	€ 0.83	11.1x	103%	90%	€ 7.00	-25%
MSCI Europe					**9-11%**		**10.8x**				

Source: 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 and from M&A activity. 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.

We are assuming that – in the next 12 months – management will continue to try "fixing" the structural issues we have identified, rather than selling assets. A divestiture of significant parts of the portfolio (the exhibition business or LexisNexis Legal & Professional) would probably trigger a re-rating of the stock. 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. 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.
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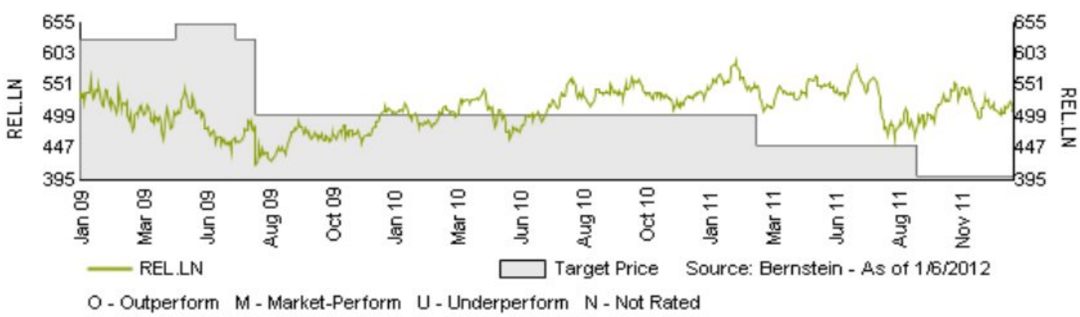
12-Month Rating History as of 02/27/2012

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

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

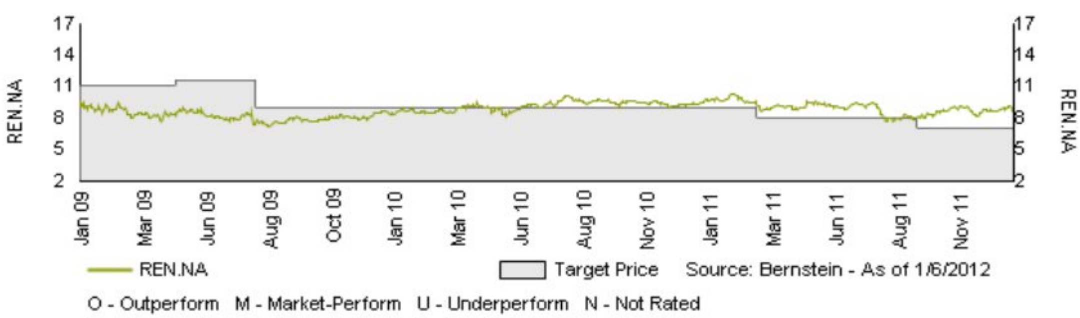
REL.LN / Reed Elsevier PLC

Date	Rating	Target(GBp)
12/11/08	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
03/10/11	U	450.00
09/14/11	U	400.00



REN.NA / Reed Elsevier NV

Date	Rating	Target(EUR)
12/11/08	O	11.00
04/29/09	O	11.50
07/31/09	O	9.00
05/07/10	M	9.00
03/10/11	U	8.00
09/14/11	U	7.00



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