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Messy 2009 – Tough 2010

Dear Reed Elsevier shareholder,

2009 proved to be a turbulent year for Reed Elsevier. In November CEO Ian Smith left the business only some 8 months after he had taken up his executive position. During his short period as CEO he managed the sudden issue of shares worth EUR 1 billion to increase Reed Elsevier's equity base. The sale of Reed Business Information (RBI) was brought to a halt under his management, because of lack of potential buyers. At the start of 2008 Reed Elsevier estimated RBI's value at Euro 1.5 billion. This estimate is no longer realistic. Of all the AEX funds Reed Elsevier only outperformed one (Aegon) with a Total Shareholder Return ('TSR') of 7.2 percent. The biggest challenge for the new CEO, Erik Engström, will be to restore the confidence of investors.

Moderate annual figures

At first sight, Reed Elsevier's turnover growth of 14 percent to 6 billion pounds is quite impressive, as is a stable operating margin of 25.9 percent. However, the reality is less rosy. The company's performance can only be maintained because Reed Elsevier has made some acquisitions, including Choicepoint. The underlying turnover, adjusted for acquisitions and currency effects, fell by 6 percent. In particular the underlying turnover for the cyclical activities RBI (minus 18 percent) and Reed Exhibitions (minus 22 percent) plummeted.

Reed Elsevier is presenting its margins favourably by adjusting the operating margin for intangible assets and goodwill, acquisitions related costs and restructuring costs. Thus the operating margin amounted to well over 1.5 billion pounds, which is 14 percent up on 2008. The VEB finds it highly doubtful that Reed Elsevier is leaving exceptional restructuring costs – severance payments and expenses related to outsourcing – aside, since the benefits of these cost advantages are expressed in the operating results. These exceptional restructuring costs amount to 182 million pounds. The real ('reported') operating profit is 787 million pounds, a margin of just 13 per cent, not the 25.9 percent reported. The difference in operating profit is also explained by an amortisation charge of goodwill and intangible assets totalling 545 million pounds.

Reed Elsevier less defensive

The huge amortisation charge regarding intangible assets looks somewhat ominous. At the end of 2009 Reed Elsevier's balance shows some EUR 9 billion of intangible assets (including goodwill). The increased shareholders' equity of EUR 1.97 billion is in sharp contrast with this. In addition, the VEB feels justified in asking whether the 'soft' assets can generate enough cash potential to prevent any future impairments. If not, Reed Elsevier's sustained equity capital position will be diminished or even negative.

During the past financial year, journals division RBI (including *Elsevier* and *AutoWeek*) was responsible for most of Reed Elsevier's write-offs. This is mainly due to a collapse in

advertising revenues (down 29 percent). Even though Reed Elsevier is drastically restructuring RBI, long-term forecasts for this division are not optimistic: ‘old media’ businesses seem to be heading for decreasing turnovers and shrinking margins. Reed Elsevier is transforming from being a broadly positioned publisher (general-interest magazines, books, scientific journals) to becoming supplier of high-quality electronic reference products - and this clear change of strategy is hardly surprising.

However, the new activities are more sensitive to the whims of the economy than had been hoped for. American law firms, for instance, purchased less data from the LexisNexis division’s legal data bases. Here the underlying operating profits fell by 6 percent. In the long term the VEB has doubts about the publisher’s new earnings model of offering data for payment. Free access to data for scientific articles is being argued for more and more and that is why the ‘new’ model may not be as profitable as Reed Elsevier might hope. In the US, prestigious universities like Stanford, Harvard and Duke have been complaining about high prices that (mainly) Reed Elsevier’s subsidiary LexisNexis charges for downloading scientific publications. Here, too, there is an ever present danger that customers will switch to free ‘open access’ publications.

All in all Reed Elsevier is less defensive than some investors might imagine. The new earnings model will also be under pressure and when it suffers a setback, the information company may have to write-off some of its intangible assets.

€ billion	2004	2005	2006	2007	2008	2009
Intangible Assets*	7,7	8,8	7,9	6,2	9,6	8,9
Shareholders’ equity	2,4	2,9	2,9	4,0	1,0	2,0
Total assets	11,2	13,3	12,7	13,3	13,3	12,7
Solvency**	21%	22%	23%	30%	8%	16%
Corrected solvency ***	-47%	-44%	-39%	-16%	-65%	-55%
Operating profit (continuing operations)	1,1	1,2	1,2	1,3	1,1	0,9
Net Debt****	3,6	4,2	3,7	0,9	5,9	4,4
Leverage rate*****	3,2	3,4	3,0	0,7	5,2	5,0

* combination of goodwill and intangible assets ** shareholders’ equity relatively high in 2007; net debts low because of Harcourt sale mid 2007 *** shareholders’ equity minus Intangible assets divided by total assets **** interest bearing debts minus cash position (calculated by VEB) ***** net debt divided by operating profit

Simplification governance structure required

Now that new CEO Erik Engström has taken over it seems an opportune moment to hold Reed Elsevier’s corporate governance structure against the light. Currently the British plc and the Dutch N.V. go side by side, and they are listed separately. According to the VEB this complicated structure should be simplified. As was shown with Fortis, a bi-national structure is extremely complex and inefficient. It also limits Reed Elsevier’s management boards in how fast they can make decisions, especially at times when they need to act urgently. A simplified structure can be attained by clearly choosing between the British legal form or the Dutch one and by choosing a single stock market quotation. This would mean the end of the various boards structures, a complicated (financial) reporting structure, the holding of double shareholders’ meetings, having double headquarters and having double articles of association. The fiscal implications of this suggested simplification would of course have to be investigated as they might bring an operation like this to a halt.

On behalf of the Vereniging VEB NCVB,

A handwritten signature in black ink, consisting of a large, stylized 'J' followed by a 'S'.

Jan Maarten Slagter, managing director

If you would like to respond to this letter, please email info@veb.net

Note: on submitting this letter on 8 March 2010, neither the annual report for 2009 nor the agenda for the shareholders' meeting was yet available. In case of any inconsistencies between the English and the Dutch version of this letter, the Dutch version will be the guiding one.