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Skate's Market Notes
August 9, 2010

Sotheby's 1H 2010 Results:
Restructuring Over, Profitable Business Model Back, Share Price Up 36% YTD

Management Takes Handsome Pay ($29mln in Incentives Paid in Q2 Alone on Top of Salaries)

Where Do We Go From Here? Target Price Reduced from $32 to $29

When we published our last major Sotheby's story on March 5 of this year, we praised the company for its progress with turnaround and increased our target price to $32 per share. Sotheby's financial results disclosed last week did not disappoint and were in line with our projections. The firm achieved a 73% growth in sales and 26% growth in net income for the first six months of 2010 compared to the same period a year earlier. The share price, which fluctuated wildly throughout the spring, has climbed back above the $30 mark, gaining 6.4% on the single day of August 6, 2010 following the release of the company's financial statement. The firm also devoted a significant portion of its press release to reporting on a robust pipeline of auctions lined up for the remainder of the year.

As the market knew of Sotheby's auction results for the first half of the year ($2.2bln in combined volume, more than twice the size of the auction trade in depressed 2009), strong topline growth was expected. This growth is not big news; the interesting news stories are found elsewhere in Sotheby's disclosure. Below we offer our take on those stories:

1. **Sotheby's Buyer's Premium Gives Way to Pressure, Negatively Impacting Long-term Profitability Outlook for the Firm**

As Skate's predicted back in late 2008, albeit later than we expected, Sotheby's did reduce its buyer's premium – from 20% to 12% for artworks over $1mln in market value. This measure was taken to keep potential buyers in the auction room instead of doing business with them through private sales where commissions had already been reduced or losing clients outright to off-auction trading venues (see our coverage of reduced commissions at Sotheby's private sales segment in our story from March 5, 2010).

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While justified from a competitive point of view[1], the measure will have an immediate, significant and lasting effect on Sotheby's operational profitability. The firm already experienced a decline in auction commission margin by 12%, or 250 basis points, in the first six months of the year, and we expect all Sotheby's operational profitability metrics to decline further when the upcoming auction results (based on a lower buyer's premium) are figured into the full-year 2010 financial results.

This forecast is also based on the fact that Sotheby's second and third largest business segments after the Auction segment in terms of revenue (i.e., the Dealer segment and Finance segment) have been in decline again this year (39% and 1%, respectively), which contrasts with the spectacular topline surge at the Auction segment.

2. Dealer Segment Demise Accelerates

The 39% revenue decline in the Dealer segment, coming on top of a 50% revenue decline in 2009 over 2008, shows that Sotheby's is effectively retreating from dealer activity as a result of its inability to find a profitable way to operate a dealer model within its structure. Unlike Christie's, which recently announced its divestiture of the Haunch of Venison dealer subsidiary, Sotheby's is simply allowing its Dealer segment to melt away. What used to be a $55mln business in revenues in 2008, Sotheby's Dealer segment is unlikely to gross more than $20mln this year. Haunch of Venison, by the way, was an even larger business with $105.6mln in revenues in 2007 from the UK operation alone[2] (by far the largest geographic segment of the company), but upon divestment from Christie's it is a pale shadow of its former self, which had also lost a lot of its important artists who did not like the idea of being tied to a single auction-dealer. Art fair operators like MCH Group (Art Basel) make no secret of the fact that dealers controlled by auction houses (including Haunch of Venison) are not allowed to participate in their fairs.

As sad as it may sound, this is actually a very good development. In cutting Dealer segment activity Sotheby's has actually managed to almost completely plug the hole; the firm lost only $1.3mln in the Dealer segment in the first six months of the year, a major improvement from the $7mln loss a year earlier. It looks like reducing its Dealer segment to a small shop with $15-20mln in revenues could be a way to keep it profitable as a unit. The question of course is whether 3-4% of the firm's revenue and essentially none of its profits actually deserve the management's time and the irritation caused to other dealers.

[1] *According to Sotheby's 6 months 2010 financial disclosure, the firm has managed to significantly increase its auction volumes and at the same time to keep its private sales business – private sales actually grew by 9% compared to 1H 2009 (see the Sotheby's 10Q form filed with SEC, page 28)*

[2] *Source: The Economist. June 2. 2010*

It looks like both Sotheby's and Christie's have now accepted the fact that expanding into the dealer business was a mistake.

3. Management Compensation: $29mln in Incentives Paid for Q2 Alone

Sotheby's management and its board of directors paid a lot of attention in the first six months of the year to developing a new incentives system for key management at the firm.

The bottom line of these changes is that Sotheby's multi-layered compensation structure has remained in place (with multiple forms of stock-based incentives and awards), additional awards have been granted and the terms of certain prior arrangements (specifically the Restricted Stock Award) have been changed in favor of the current management to move Restricted Stock Plans approved in 2003 and into 2006 back "into money." Apparently, the market crash of 2008 and subsequent meltdown of Sotheby's financials and share price had a direct affect on the company's incentives-based management compensation, as none of its share price and profitability KPI had been met as of June 30, 2009.[3] The board of directors (and specifically the board's compensation committee that has authority on related remuneration decisions and is led by Robert S. Taubman) seemed to be sufficiently pleased with the management's performance throughout 2009 and approved amended compensation packages earlier this year to "provide continued motivation and additional years of retention incentives to the senior executives receiving the awards" as per p.19 of 10Q disclosure form filed by Sotheby's last week.

Management compensation is increasingly developing into a material issue for the firm. We estimate that the various incentives programs (including Shares Based Payments, Restricted Stock, Performance Share Units and Stock Options) and excluding certain additional cash payments linked to performance add up well to over $60mln in costs to the firm spread out over 2.5 to 5 years depending on the program and individual arrangements. Some of the effect was immediate and seen in the second quarter already: salaries and related costs grew by over 50% at Sotheby's in Q2 2010, thereby becoming the fastest growing expense item at the firm. This cost increase was not caused by expanding headcount or salary increases (in fact salary costs were down 7% and employee benefits by 46% during Q2 compared to the period a year earlier) but instead can totally be explained by a surge in incentives-based compensation that went from $2mln to $29mln in Q2 2010 (compared to Q2 2009), or from $4mln to $31mln if calculated on a six months basis. In other words, incentives-based compensation paid to Sotheby's executives in the first six months of the year exceeded over a third of Sotheby's net income for the same period.

[3] According to 10Q disclosure, p.19: *"…256,519 of these Restricted Stock shares that were available to vest on June 30, 2009 did not vest. Additionally, the 427,531 Restricted Stock shares that were available to vest on June 30, 2011 were not expected to vest."*

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4. Other Interesting Disclosures

There are two other notable disclosures made in Sotheby's recent 10Q filing with the US SEC.

First, the firm made an unusually detailed disclosure on one of its guaranteed transaction deals. The company has apparently withdrawn guarantees for most of its consigners but continues with the practice where it can source a third party "Plan B" bid that allows Sotheby's to share financial risk with such a party in the unfortunate event that the consignment does not sell at auction and/or sells below the guaranteed price. At the report was prepared, November auction catalogues had not yet been published by Sotheby's, but its financial disclosure (below) will make us watch as it points clearly to one guarantee arrangement that Sotheby's has put in place with its consignor for that auction:

"As of July 27, 2010, Sotheby's had an outstanding auction guarantee of $47 million, with the related property having pre-sale low and high estimates (1) of $45 million and $60 million, respectively. Sotheby's financial exposure under this auction guarantee is reduced by an irrevocable bid from an unaffiliated counterparty of $44 million. If the irrevocable bid is the winning bid for the property underlying the auction guarantee, the total proceeds from this irrevocable bid would be $49.4 million, consisting of the payment of the irrevocable bid ($44 million) plus the payment of the related buyer's premium ($5.4 million). The property related to this auction guarantee will be offered at auction in November 2010. In July 2010, Sotheby's advanced $20 million of the guaranteed amount to the consignor."[4]

Second, the firm continues to maintain very special terms for some of its clients, including allowing them to take possession of artworks purchased via Sotheby's without paying for them (but agreeing to pay in the future). Out of $667mln in accounts receivables, Sotheby's reported $66.5mln in receivables related to such situations where art had been shipped but buyers had not yet paid (and where Sotheby's was already liable for payment to sellers). While the volume of such "special terms" transactions remains largely unchanged compared to prior periods[5] (at the same time general volumes of sales and receivables grew significantly) it is nevertheless interesting that Sotheby's management finds it justifiable to maintain such special conditions for a select group of clients who are essentially provided capital to enter transactions with art at Sotheby's expense.

[4] *Source: Sotheby's 10Q form filed with SEC, page 17*
[5] *Source: Sotheby's 10Q form filed with SEC "…As of December 31, 2009, net Accounts Receivable of $373.7 million includes $67.9 million related to transactions in which Sotheby's has allowed the buyer to take possession of the property before payment is made. Included in this amount is $21.2 million related to transactions when Sotheby's has paid the consignor before payment is collected from the buyer in addition to allowing the buyer to take possession of the property".*

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5. **Outlook for 2010/2011**

As we enter the new auction season, Skate's believes that most of the good news for Sotheby's this year is over. The turnaround has been completed, the company's management has been well paid, and now the hard work remains for the firm to identify further areas for long-term growth.

At a current market capitalization of over $2bln and its share price over $30 and close to Skate's target level of $32, Sotheby's is fully priced. The management is the first to accept the fact that while the pipeline remains strong, it is unlikely that the stunning auctions which took place in the first half of the year will be repeated. And apart from auctions, the firm has no other long-term source of growing profits with the possible exception of licensing revenue, which remains too small to have an effect at present.

Given the reduction of the buyer's premium earlier this year and the increased management incentives adopted, Sotheby's has negatively affected the profitability of its business model going forward. Skate's therefore reduces the share price target to $29 for the year and will watch new strategic initiatives at Sotheby's with utmost attention as an indication of whether the firm can deliver any substantial growth for shareholders going forward.