Skate's Art Market Research

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Sotheby's Reports 2010 Results

Stellar Numbers, but Growing Exposure to an Expanding Art Loans Book

As expected, Sotheby's came back strongly in 2010. The firm returned to profitability, and its key financial metrics are now positioned at 2006 to 2007 levels. The old business model is working well again; Sotheby's saw net income of $161 mln, which translated into an impressive 20.8% net profit margin. The only better year in recent memory was 2007.

Table 1: Sotheby's Key Financial Indicators

USD '000	*2010*	*2009*	*2008*	*2007*	*2006*
Net Auction Sales	3,644,764	1,912,589	4,189,735	4,625,914	3,234,526
Auction and related revenues	731,021	448,768	616,625	833,128	631,344
Finance revenues	9,685	9,073	14,183	17,025	15,864
Dealer revenues	29,092	22,339	55,596	62,766	12,776
License fee revenues	3,682	3,270	3,438	2,960	2,922
Other revenues	829	1,508	1,717	1,843	1,903
Total Revenues	774,309	484,958	691,559	917,722	664,809
Net Income (loss)	160,950	(6,528)	26,456	213,139	107,049
Average Commission Intake (Intake Ratio)	20.1%	23.5%	14.7%	18.0%	19.5%
Non-auction revenues	5.6%	7.5%	10.8%	9.2%	5.0%
Net profit margin	20.8%	-1.3%	3.8%	23.2%	16.1%

Source: Sotheby's EDGAR filing (10k), calculations performed by Skate's Art Market Research

Skate's has traditionally watched a set of key performance indicators (KPI) that we have developed to measure and analyze the firm's performance. Perhaps the most important KPI is the average commission intake (Intake Ratio), which is calculated as the firm's auction segment revenue as a percentage of auction turnover. This measure shows whether the company faces pressure to lower its commissions with respect to alternative art markets and rival auction houses. The number for 2010 is exceptionally strong; Sotheby's achieved an average 20.1% gross commission on the auction volume it serviced, which is largely due to its ability to increase seller commissions along with the growing volume of private treaty sales that the company continues to report within the auction segment (i.e., as opposed to allocating them to the

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dealer segment). As a result, the Intake Ratio is calculated on a lower volume of turnover that excludes the volume of private treaty sales but includes private treaty commissions. Sotheby's very cleverly manages the volume of its trading mix by focusing on growing auction volumes where margins are optimal (net auction sales grew by 90.6% in 2010) and maintaining a fairly stable book of lower-commission private treaty sales for more demanding clients and price sensitive transactions that are seen as having no place in the auction room due to their "value destroying" nature. These lower-commission private treaty sales stand at approximately $0.5 bln per annum, a figure that grew by just 4.6% in 2010.

While the auction model works, it is also Sotheby's only material business today. The firm has so far failed to diversify away from the auction business, and its non-auction revenues contributed to merely 5.8% of the company's total sales in 2010. It is no wonder, therefore, that the firm's share price continued its longstanding trend of responding strongly to the outcome of its largest auctions, thus pointing to the success of large auction sales as one of the key drivers of Sotheby's financial performance.

Finally, net profit margin is key to assessing the firm's cost discipline and ability to avoid costly write-offs. After a disastrous 2008-2009 in terms of net profit margin (significant 2008 write-offs caused by guarantees followed by the meltdown of auction trade volumes in 2009), Sotheby's has returned to a respectable 20.8% net profit margin.

The sharp reduction of Finance segment activities and the avoidance of risky loans and guarantees have contributed to this strong profitability; Sotheby's largely avoided the losses and write-offs generated by the segment in 2008 and 2009. However, in 2010, as the market began to look strongly bullish again, Sotheby's began taking more risk in its loan business. The firm considers loans with an LTV of 50% or more to be relatively high risk. For 2010, it discloses that the volume of such risky loans with an LTV of 50% or higher roughly doubled from $69.4 million as of December 31, 2009 to $133 million as of December 31, 2010. On average, nearly half of all Sotheby's outstanding loans (in dollar terms) were given to consigners against their art at an LTV above 50%, which gives the firm fairly open exposure to adverse market conditions. Thus, auction sales are important not only as key drivers for Sotheby's financial performance but also as triggers for the company's exposure to the book of loans made to its customers. These loans grew from $164.5 million to $277.3 million in 2010 alone. As strong as Sotheby's turnaround appears today, the firm is very exposed to abrupt market changes and could be plunged into a single digit net income margin after just one bad auction cycle.

On a positive note, while Sotheby's financial exposure resulting from loans to clients is clearly on the rise, the firm has mastered a basically risk-free practice of giving guarantees to consigners and hedging those with irrevocable bids. As of December 31, 2010 the firm had $34.3 million in guarantees outstanding with virtually the entire amount ($32 million) hedged with irrevocable bids.

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Given the short-term nature of guarantees and consignor loans, as well as their aggregate volume of just above $300 million, it appears that Sotheby's needs to offer loans or guarantees on approximately 15% of the lots consigned (in dollar terms), thus making risk management of this financial aspect of Sotheby's business an integral part of its auction business these days.

Perhaps the other area of growing importance at Sotheby's are its expenses related to management incentives. In a classically American manner, the handsome pay received by the firm's management is linked to good performance. With spectacular growth of top line, bottom line and market capitalization, Sotheby's management convinced the Board to pay essentially as much in bonuses and employee benefits as its total payroll for the year. While the firm kept payroll at $114 million, basically unchanged over the 2009 level, its incentive compensation payouts (concentrated around the key people within the firm) ballooned from $18 million to $68 million (share-based and employee benefits added another $37 million in 2010, the same as in 2009). In other words, the management took home around one third of 2010 net profits in bonuses alone, or approximately four times more than the total dividend payout to all of Sotheby's shareholders in 2010. Putting the issue of fairness aside, the key question is whether it will be possible for Sotheby's Board of Directors to continue such incentives for its already handsomely paid management going forward. On the one hand, it may run the risk of appearing unreasonable, while on the other hand it could risk its key people losing energy and commitment to achieving new corporate goals. Bringing younger and "hungrier" management to Sotheby's senior executive level might make a lot of sense as a succession strategy. Hopefully the Board's compensation committee is paying attention.