Skate's Art Market Research

155 East 56th Street, 4th floor, New York, NY 10022 USA /phone: +1.212.514.6010

August 10, 2011

Skate's Market Notes

Sotheby's Six Month Report: Strong Results Lead to Astonishing Cash Numbers with Private Sales Becoming the Fastest Growing Line of Business; Dutch Exit and China Acquisition; Strong Buy Rating from Skate's

Over the past several weeks, a rollercoaster ride on global equity markets has taken investors' attention away from news on individual companies and resulted in a massive sell-off of shares across the board. Although the impact of S&P's U.S. debt downgrade and continued European debt troubles have yet to be fully digested by the market, now is a good time to revisit the fundamentals and take a closer look at the financial results of the major companies that make up Skate's Art Stocks Index.

In this issue of *Skate's Market Notes*, we will profile Sotheby's, which published its second quarter and first half results on August 3 (the full report can be found at Skate's Art Stocks & Funds section at www.skatepress.com).

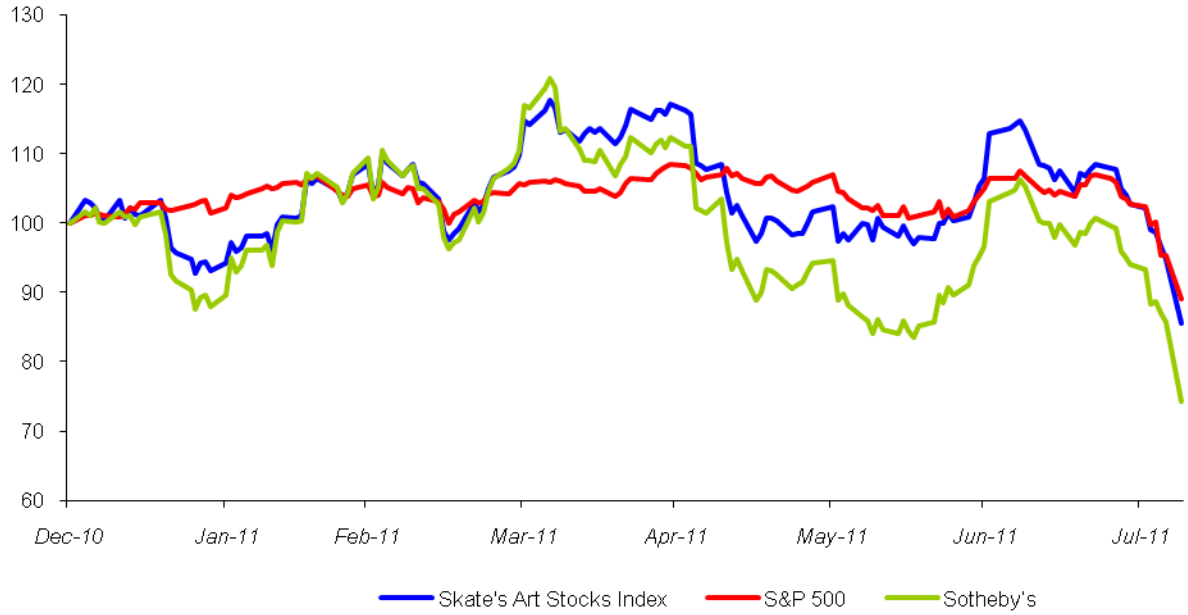
In our upcoming issues of *Skate's Market Notes*, we plan to cover the following topics:

August 15, 2011 – Artnet (6 months results and review of Artnet's online trading strategy)
August 22, 2011 – Collectors Universe (6 months results)
August 31, 2011 – Changes in Skate's Art Stocks Index (addition of a new stock)
September 7, 2011 – MCH Group (6 months results)

Sotheby's Business Model Shines: Firm Could Score $1 bln in Private Dealing Volume This Year

In announcing its six months results, Sotheby's once again made the point that the art industry has had no better business model than the one belonging to the prominent auction house. Furthermore, no company has exceeded Sotheby's in terms of transparency and level of disclosure, although Collectors Universe and Artnet are on par in terms of transparency.

Exhibit 1: Sotheby's Share Price vs S&P 500 and Skate's Art Stocks Index, YTD



Source: Skate's Art Market Research

Driven by economic recovery and steady demand for high-end works of art from global high net worth individuals, Sotheby's revenues grew by 27.7% in the first six months of 2011 in comparison to the same period of 2010. EBITDA grew by 33.5%, and net income shot up by 54.2% for the same period. The profitability metrics are simply stunning: Sotheby's operated at a 42.4% EBITDA margin in the first six months of the year (40.6% for the same period last year) and at a 26.5% net income margin (21.9% for the same period last year).

Sotheby's aggregate auction sales grew at an even faster rate of 37.6%. As a result, the firm's average commission intake went from 19.1% to 12.7%. While Sotheby's tends to explain this trend as being the result of increasing competitive pressure and a greater share of higher-value lots that trade at lower commission rates, Skate's believes there is another powerful factor at play. Sotheby's has increasingly employed a discriminating fee structure that favors strategic clients, which, along with its promotion of private sales, guaranteed bids and other innovative forms of art dealing, has served to reduce transaction expenses. This strategy clearly helps to grow auction volumes, but Sotheby's has been even more successful in stimulating private sales, which more than doubled to $448 mln in the first six months of the year in comparison to the same period last year. Volume and top line grow nicely, but the commission intake ratio fell as private treaty sales and purchases through guaranteed bids came with lower transaction expenses for Sotheby's clients. According to its 10Q form, Sotheby's made approximately $36 mln in commissions from private treaty sales in the first half of the year, which implies a transaction cost of less than 9% for buyers and sellers combined.

This aggressive fee policy might help Sotheby's exceed $1 bln in private transaction volume this year, which would make it one of the largest art dealers globally. Private sales are by far the fastest growing part of Sotheby's operations. In an apparent attempt to avoid advertising this stealth move to clients, galleries and other dealers, Sotheby's has developed a creative accounting policy that excludes the private sales business from the Dealer segment, which remains tiny and static in its GAAP segment disclosure. The truth is that Sotheby's will become a $1 bln dealer in terms of trading volume this year, running about 20% of its turnover off auction and consistently eating away market share from high-end art dealers around the world.

Cash, Debt and China

A clever business model has helped Sotheby's to do what any good business should do, i.e., to generate loads of cash. In the six months of the year to date the firm has increased its cash position by 37.7% to reach an apocalyptic $666 mln. The meaning of this number is actually very positive given the turmoil in Sotheby's finances just a few years ago – Sotheby's is now debt free on a net debt (i.e., total debt less cash) basis.

That said, Sotheby's continues to carry a lot of debt, and the long-term portion of it alone is $461 mln. The company paid $21 mln in interest expenses for the first six months of the year. On top of that, it had to service conversion obligations on its Convertible Notes program that allowed its bondholders to benefit from an early conversion clause owing to the high price of Sotheby's earlier this year (one trigger stipulates that the share price has to be above $44.20 per share for 20 consecutive trading days, a condition that has been in place twice this year so far). The firm is also in no rush to repay its debt. As of June 30, 2011, the aggregate future principal and interest payments due under the York Property Mortgage, the Convertible Notes and the Senior Notes are as follows (in thousands of dollars):

July 2011 to June 2012	$45,851
July 2012 to June 2013	$209,769
July 2013 to June 2014	$22,202
July 2014 to June 2015	$102,173
July 2015 to June 2016	$219,516
Total future principal and interest payments	*$599,511*

In its disclosures Sotheby's vaguely refers to certain expenses it had incurred so far this year to review various strategic expansion options. Sitting on nearly $700 mln in cash, it would have been better for the firm to distribute it to shareholders or invest in future growth.

Now could be a perfect time to buy an auction house in China (see Skate's related story on the subject at http://www.skatepress.com/files/Skates_Market_Notes_07262011.pdf). Skate's expects that Sotheby's would be reviewing strategic acquisition and expansion options in China as of this report's publication.

Caution with Financial Services, Exiting the Netherlands after Five Years of Struggle

Unlike in prior years of growth, Sotheby's has been very prudent with its finance segment. It has made almost no effort to expand its business there and has reported essentially no losses to speak of from guarantees and loans. It has remained very conservatively focused on top-lot auctions, private sales activity and the maximization of revenue per core account. The group's loan portfolio grew strictly in line with the volume of auction sales (38.4% and 37.6%, respectively, in the first 6 months of 2011 compared to the same period of 2010), which suggests that Sotheby's management has imposed strong discipline on the share of auction consignments taken under loan programs with consignors. The average loan portfolio currently stands at $227.4 mln, which implies that collateralized art (assuming 50% LTV) is approximately 10% of Sotheby's annual auction volume. Art loans risks are often offset with irrevocable (guaranteed) bids from third parties, and the LTV ratio rarely exceeds 50% - all in all confirming decent risk management at Sotheby's.

The extent to which art loans were and remain a murky business is demonstrated by a recently disclosed litigation arising from a double pledge. In May 2009, Sotheby's accepted the pledge of an art collection to secure a loan extended by Sotheby's Financial Services only to learn later that this collection had been pledged to another financial institution (Dutch Friesland Bank NV), which eventually sued Sotheby's, with both parties settling on June 3, 2011.

This litigation, coupled with five years of losses incurred in Sotheby's Dealer segment built around the acquisition of Dutch Noortman Master Paintings (NMP) business in 2006, has prompted Sotheby's management to pull the plug on the firm's presence in the Netherlands. The acquisition did not work (from Sotheby's 10Q form, p.19: "pursuant to the Purchase Agreement, if NMP failed to achieve a minimum level of financial performance during the five years following the closing of the transaction, up to 20% of the Initial Consideration will be transferred back to Sotheby's. The minimum level of financial performance was not achieved as of June 30, 2011, and as a result, approximately 150,000 shares of Sotheby's Common Stock will be transferred back to Sotheby's in the third quarter of 2011"). The litigation with the Dutch Bank has been settled, and Sotheby's management is free to close the door on the Netherlands almost immediately.

Exhibit 2; Disclosure of Sotheby's Litigation

Friesland Bank NV (the "Bank" *) v. Sotheby's Financial Services Ltd. and Sotheby's (* the "Sotheby's Parties") was a dispute between the Bank, which is located in the Netherlands, and the Sotheby's Parties regarding the priority of their respective pledges over a U.K. collection of books and manuscripts (the "U.K. Collection") owned by Joost Ritman, a Dutch national. Pursuant to a Loan, Private Treaty Sale and Consignment Agreement dated May 29, 2009 between Mr. Ritman (and Ritman owned entities) and the Sotheby's Parties (the "Sotheby's Agreement"), Mr. Ritman pledged the U.K. Collection to Sotheby's Financial Services Ltd. as collateral for a loan made by Sotheby's Financial Services Ltd. in the sum of €5 million. In November 2010, the Bank notified the Sotheby's Parties that in July 2005 Mr. Ritman had entered into a prior Deed of Pledge with the Bank and that the U.K. Collection formed part of the collateral for the Bank's loan to Mr. Ritman in 2005 in the sum of approximately €20 million. In April 2011, the Bank commenced legal proceedings against the Sotheby's Parties. The issues between the Bank and the Sotheby's Parties were whether (i) the later English possessory pledge to the Sotheby's Parties had priority over an earlier Dutch non-possessory pledge to the Bank and whether (ii) the Sotheby's Parties were on actual or constructive notice of the existence of the earlier Dutch non-possessory pledge to the Bank at the time that they entered into the Sotheby's Agreement in 2009. The litigation commenced by the Bank against the Sotheby's Parties was settled on June 3, 2011 and the legal proceedings have been discontinued. As a result of the settlement, the loan and any related interest have been paid in-full.

Source: Sotheby's, Form 10Q dated Aug 4, 2011, p.38

On June 27, 2011, the Executive Committee of Sotheby's Board of Directors approved a restructuring plan (the "Restructuring Plan"). In the Netherlands, the Restructuring Plan will result in the cessation of all local auction sales. In Italy, Sotheby's will significantly reduce its auction sales calendar, but it plans to continue to hold auctions of Contemporary and Modern Art. The Restructuring Plan will reduce staff by 23, which represents approximately 45% of Sotheby's current headcount in Italy and the Netherlands and 2% of its global headcount. The Restructuring Plan will also allow Sotheby's to completely exit its leased Amsterdam salesroom facility, replacing it with a smaller local office, and significantly reduce the cost associated with its Milan premises (quoted along the lines of 10Q Form).

Share Price

As of publication, Sotheby's share price is down 26.67% YTD and significantly underperforming both the S&P 500 and Skate's Art Stock Index. This is wrong. With today's close of $33.00 per share, Sotheby's is traded a full $11 below Skate's target price of $44. We rate the stock as a strong buy at current price levels.