

Skate's Art Market Research

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

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Skate's Market Notes

artnet Results Disappoint, Minority Shareholder Increases Ownership Interest

artnet has released its financial results for nine months ending September 30, 2011. They are disappointing. The firm continues to be loss making, revenues remain flat and artnet's major hope, online art auctions, produced just 12.8% growth on a y-t-y basis and remains its second largest loss making business unit (after its magazine publication business). Perhaps the only interesting new development at artnet came from its mandatory disclosure on changes in significant shareholdings; the company's long-term minority investor—San Francisco-based Artis Capital Management LLC—doubled its ownership interest in artnet over the course of 2011 and now owns 15.13% of the firm.

Skate's believes that artnet under Hans Neuendorf's leadership is reaching a point where significant change might be needed, which could be stimulated by the rise of a potential activist shareholder. We met Mr. Neuendorf this week and learned that apart from a new analytics product launch the firm is planning for this December, everything else remains business as usual at 61 Broadway.

Galleries Spend More on their Online Strategy but Defect to Other Platforms

A well detectable market trend has emerged: (1) art galleries are moving online, investing in their websites and experimenting with new platforms. The vibrant New York VIP Art Fair, now with a new CEO coming from the e-commerce industry, provides the most noticeable evidence that galleries are spending money on online distribution channels; and (2) consumers are turning to online art trading sites, a phenomenon which has given rise to a myriad of new online art trading platforms lately (Skate's is now tracking 16 online trading platforms globally, whose trading volumes are all growing at different rates).

artnet, the pioneer of internet applications in the art trade, should be benefiting from this trend greatly, but our analysis shows this is actually not the case. artnet's internet auction volumes grew but at a modest rate (see further discussion below). At the same time, the galleries seem to be defecting to other platforms; the meteoric rise of VIP Art Fair, which acquired over 100 galleries for its second edition in February 2012 despite technical glitches at its debut online fair in January, is one example. Another case is a marketplace model being tested by Saatchi Online. Launched by the legendary London-based

Saatchi Gallery in 2006, this initiative recently gained the backing of the deep-pocketed Balderton Capital, one of the most savvy e-commerce investors globally.

While art galleries and dealers invest in alternative internet-based distribution channels, artnet's Gallery Network business unit continues to shrink. For the first nine months of 2011 its sales declined by 7.5% in euro terms to EUR 3.6 million. Skate's posits that VIP Art Fair will produce comparable revenue in 2012 and can catch up with artnet's Gallery Network segment in 2013 in revenue terms, i.e. after just three years in business.

Free Price Data Continues to Kill Profitability of artnet's Price Database

Increased use of the internet in the art trade has served to stimulate the wide availability of auction price data online and is inevitably leading to the commoditization of art price information, which so far remains the largest source of profits for artnet. The firm's Price Database segment revenue declined by 5.4% in euro terms in the first nine months of 2011 (compared to the same period of 2010), while the segment's profitability plummeted by 26.9%. This destruction of artnet's Price Database segment profitability is the primary reason for overall widening losses at artnet, from EUR 51,000 (nine months of 2010) to EUR 80,000 in the first nine months of 2011.

artnet does have a strategy to counter this decline, which involves introducing value-added analytics services and detailed by-artist price indices. These are based on a proprietary methodology of splitting an artist's creative legacy in strings of comparable artworks and creating an in-depth analysis of historical price data on that basis (adjusting for descriptive factors and thus simplifying peer group-based pricing process for artworks for its users). The new product is scheduled to debut in December, and we will wait to see whether it helps reverse the worrisome performance trend of artnet's Price Database segment.

Online Art Auctions Not Growing – Why?

artnet attributes the modest growth rates for its online auction (12.8% to EUR 1.59 million for the first nine months of 2011 compared to the same period of 2010) to the weak economy and slower demand for the lower-value art items traded at artnet. artnet also expects a very strong fourth quarter for its auctions, so we will hold off on our assessment of the Auction segment's performance until the full year results are published by artnet early next year.

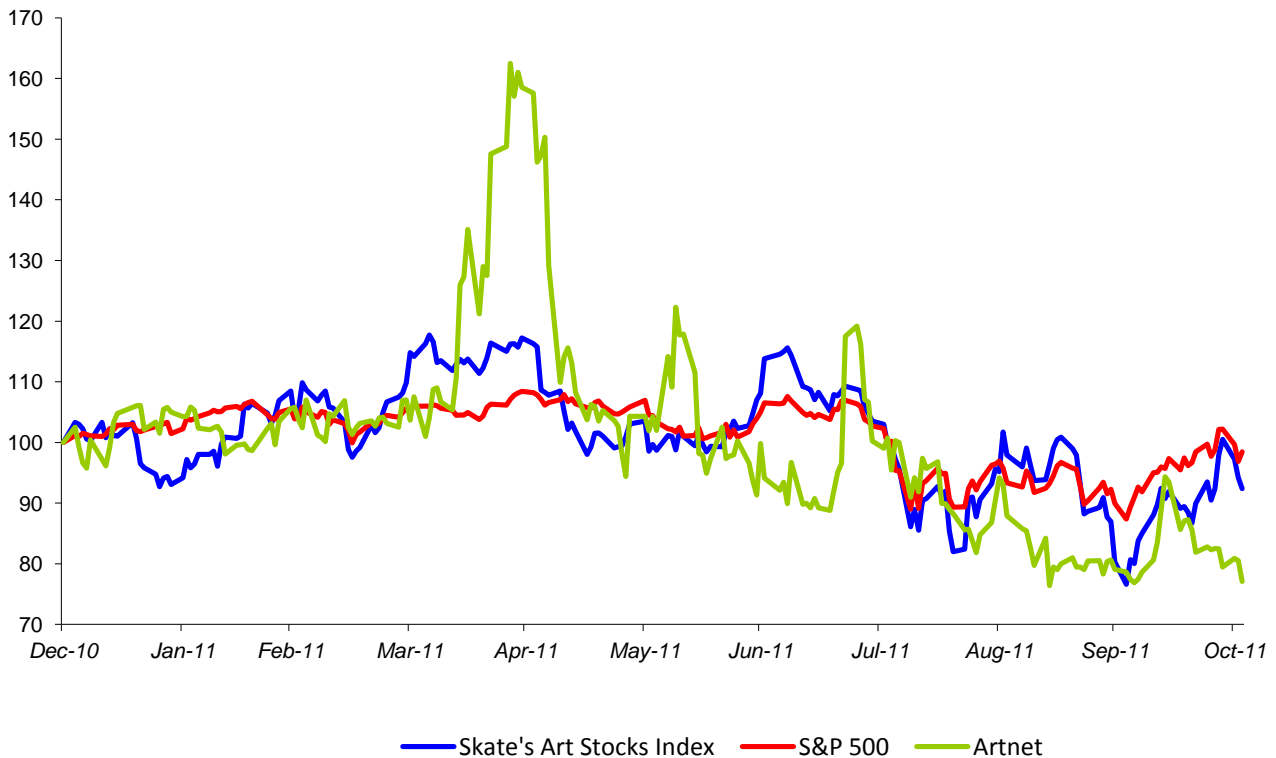
That said, Skate's believes the true source of this disappointing growth rate lies in the much tougher competitive landscape artnet is now facing compared to three years ago when it entered the market with its online auction offering. As mentioned above, at least 16 strong competitors (including artnet) are racing for art market e-commerce leadership now, and artnet has failed to translate its first mover advantage into tangible volumes that preclude new players from entering the market. Nevertheless, artnet continues to enjoy significant competitive advantages, such as its price database and ability to manage risks pertinent to art dealing online (e.g., wrongly authenticated artworks, art with compromised title, etc). The firm has a clean track record in the space so far, thanks to long established relationships with dealers that act as vetting agents for art sold on artnet's auction platform. There is

still a good chance that artnet could secure a market leadership position in the online art trading space, but time is quickly ticking away and the early successes of Paddle8 and Saffron art (to name a few) coupled with the arrival of well-funded competition, such as Saatchi Online, could marginalize artnet's auction business very quickly in the eyes of a growing army of online art buyers.

Executive Summary

Three months ago we concluded our six months report on artnet by saying "We are standing behind our original recommendation of EUR 6.5 per share and looking forward to new ideas from artnet management." We appreciate artnet sharing information about its new analytics product with us, but we believe it will not be enough to avert continued decline in the price database business. Furthermore, it does not address our key concerns about galleries shifting their internet spending to other platforms and artnet's online auction competitiveness in an increasingly crowded market. That said, we are reaffirming our EUR 6.5 per share target price for artnet. We see substantial equity value in the company on top of the current market cap and believe that artnet could quickly provide revenue growth and offer a profitable business model when and if the company makes significant changes to its value management strategy and focuses on rebuilding itself as the dominate e-commerce platform in the contemporary art space. One major step to a turnaround would be for the firm to ceases its attempts to play with old toys like its magazine, which managed to lose EUR 725,000 on sales of EUR 77,000.

artnet Share Price Performance versus Skate's Art Stock Index and S&P 500



Source: www.skatepress.com