Skate's Art Market Research

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

November 10, 2011

Skate's Market Notes

Is There a Better Business Model for the Art Trade than the Auction House? Yes, There Is!

The traditional mismatch between Sotheby's robust auction volumes and the firm's third-quarter loss-making financials, which were released at the same time (this week, actually), causes us to pose a legitimate question: while the auction has clearly been the best art industry business model to date (eight of the 13 constituent companies in Skate's Art Stock Index have art auctions contributing to at least part of their economics), one may wonder if there is a better way to make money in the art industry. Can a company do better than living from one peak season to another, losing money between auctions and staking a significant part of its fortune on a single week of trade several times a year?

Skate's believes that yes, there is a better model out there. It is currently practiced in the low-key world of collectibles and has not yet migrated to fine art market. The fine art market would be better off if it did.

Our favorite company in art industry this year has been Collectors Universe, the humble West Coast-based collectibles marketplace operator. Coins contribute to two thirds of the company's volume, and it is the global leader in the business of authenticating and grading coins. Put quite simply, our pick for the art world's best business model is grading and authentication.

Collectors Universe just released its Q1 2011/2012 financial results (three months ending September 30, 2011, see details at http://www.skatepress.com/?cat=54), and reported that it had processed 835,800 units of collectible items (coins, trading cards, autographs and stamps), which was a 5% increase in volume terms compared to the same period of last year. All of those items were authenticated and graded by Collectors Universe for its clients, and for this quarter alone the firm made $12 million in revenues and $2.5 million in EBIT on these services. We have been tracking this company since 2005, and it has been consistently profitable when focused on its core authentication and grading business for low-cost collectibles (Collectors Universe unsuccessfully experimented with diamonds and exited this business in 2009). Profitability has been steadily improving over the last few years, with the company experiencing little or no cyclicality and achieving 12.2% on a net profit basis for the last quarter (ending September 30, 2011).

Today's Collectors Universe is debt free, has over $20 million in cash, grosses about $50 million in sales per annum and operates with a 12% net income margin. The market currently values the company (traded under the CLCT ticker on the NASDAQ exchange) at $120 million (market cap). This is five times the market cap of artnet and comparable with exhibitions giant and Art Basel operator MCH Group. Its net profitability margin is the best in class (i.e., within Skate's Art Stock Index). It should be noted that Collectors Universe achieves this performance by servicing a market where the average value per collectible unit is $444.10 (in the first quarter of 2011) and declining (the figure for the first quarter of 2010 was $451.00).

Clearly, grading and authentication is a well tested model but it is used for the market with the least value of graded items. Collectors Universe experimented with diamonds and failed. This failure came as no surprise, as the move was a bad one for the company, but Collectors Universe would do well to move into the contemporary art world and establish itself as a market leader in grading and authentication services. Such a move would have a multiplier effect of roughly 1,000 times when it comes to key business model drivers like value per item, fees charged and profits made. The barrier to entry is relatively low, at least for the art market's contemporary segment.

Unfortunately, Collectors Universe was burned with its diamonds expansion and is now playing it safe by making esoteric acquisitions like Coinflation.com for $0.72 million and betraying no hint that it might be interested in thinking about art. This is sad, and for now it means that the current valuation is well deserved. Unless Collectors Universe moves into the sexier contemporary art space it will be locked in the oblivion of servicing low end coins and experiencing $150-200 mln as its best equity value case for years to come.

Outperformer: Collectors Universe versus S&P 500 and Skate's Art Stocks Index