Sotheby's Fourth Quarter 2016 Earnings Call Outline

27 February 2017

Safe Harbor: GAAP refers to Generally Accepted Accounting Principles in the United States of America. In this earnings call, financial measures are presented in accordance with GAAP and also on an adjusted non-GAAP basis. An explanation of the non-GAAP financial measures used in this earnings call, as well as reconciliation to the comparable GAAP amounts is provided in the Company's Form 10-K for the period ended December 31, 2016. Also, during the course of this call, the Company may make projections or other forward-looking statements regarding future events or the future financial performance of the Company. We wish to caution you that such projections and statements are only predictions and involve risks and uncertainties, resulting in the possibility that the actual events or performance will differ materially from such predictions. We refer you to the documents the Company files periodically with the Securities and Exchange Commission, specifically the Company's most recently filed Form 10-K. These documents identify important factors that could cause the actual results to differ materially from those contained in the projections or forward-looking statements.

SPEAKER: Tad Smith, President and Chief Executive Officer

Thank you for joining us, and for your interest in Sotheby's.

- This morning I will begin with a look at our fourth quarter results before turning to the market and the current environment. I will end with an update on our four priorities.
- On our last analyst and investor call, we anticipated fourth quarter 2016 Adjusted EPS* to be in line with 2015's figure and, in the end, we came in 13% higher with Adjusted EPS* of $1.35, driven largely by a number of outstanding fourth quarter sales. For the full year, we reported Adjusted EPS* of $1.71, down 17% from 2015 Adjusted EPS* of $2.07.
- There are three key takeaways from the quarter's results:
    - First, we were cautiously optimistic in November but as it turns out, the weight in that statement should have been on optimism as collectors responded enthusiastically to the great collections and works we secured for sale;
    - Second, greater pricing discipline and intelligent deal-making contributed to yet another quarter of improved auction commission margins;
    - Third, and most importantly, this quarter demonstrated that when the market stabilizes, let alone when it returns to its secular growth trajectory, our company is poised to capitalize on the upturn and do very well for our shareholders.

- Turning to the first quarter of 2017, some have noted that that our Masters Week sales in January were lower than a year ago, but there are two factors that are important to acknowledge:
    - This season we did not have a masterpiece like the Gentileschi we sold to the J. Paul Getty Museum in 2016 for $30.5 million, nor did we have a $24 million single owner sale as we had with the Taubman Collection. When you remove both of those from the equation, our results were nearly flat at $41.9 million and with strong prices achieved across paintings, drawings and sculpture.
    - Our Americana Week sales totaled $19.4 million, our best result in a decade, anchored by the performance of an impressive number of distinguished private collections. More than 1,000 lots were sold across six auctions, with a strong overall sell-through rate of 80.4%.
- Looking ahead – our major sales of Impressionist, Modern and Contemporary art get underway on Wednesday night in London and we are encouraged.
    - Our Impressionist & Modern Evening Sale is led by a beautiful landscape by Gustav Klimt that is estimated to sell for more than $45 million. The sale also includes several important works by Pablo Picasso including his *Plant de tomate* from 1944, which is estimated at $12.4 / 18.6 million.
    - The top lot of our Contemporary Evening Sale is a monumental canvas by Jean-Michel Basquiat entitled *Untitled (One Eyed Man or Xerox Face)*, which is estimated at $16.1 / 21.9 million. The sale also includes an outstanding group of German works led by Gerhard Richter's *Iceberg*, which was painted in 1982 and is estimated at $9.8 / 14.6 million.
- Our Hong Kong team is in the final stages of assembling their spring sales so it's a bit early to provide guidance on what we are seeing in that market.
    - However, last year, 48% of purchases by Asian clients took place outside of our Hong Kong salesroom, a trend that we began to see in 2013;
    - And of the top ten works sold by Sotheby's in 2016, half were purchased by buyers from Asia.
    - Moreover, we are very pleased that our relationship with our new largest shareholder has already been helpful to us in China.
    - Lastly, it's important to remember that there is much more to Asia than China. We are tremendously excited about opportunities in Taiwan, Singapore, India – where we recently opened a new office in Mumbai – and Japan, where we are under new management.
- Looking more broadly at the market, there are also a number of macro factors at play and how they may impact the market and our business remains to be seen and it's important for us to continue to monitor a number of situations:

    - In the U.S., we obviously have a new administration that is looking at tax reform and economic and regulatory policies that might affect the art market or Sotheby's. We are watching those developments closely and I am happy to speak more to the topic in the question and answer period.
    - In the U.K., Brexit is another factor we need to keep an eye on – in the short term, exchange rates present a favorable opportunity in our London salesroom for non-British buyers, but what will happen in the longer term depends on the U.K.'s exit agreement and the nature of the legislation that is put in place.
- Turning now to our progress against our four priorities, and as a reminder they are:
    - First, to implement a compelling growth strategy.
    - Second, to embrace technology more effectively both internally and through client-facing products.
    - Third, to build a talented team within the organization and the processes to sustain success.
    - Fourth, to allocate our capital more efficiently.

<u>With respect to the first priority</u> – to implement a compelling growth strategy:

- I already touched on our upcoming March sales in London, but a brief recap of our performance in 2016 demonstrates our progress on improving our position at the high end of the fine art market and our results speak for themselves:
    - Last November, our Impressionist, Modern & Contemporary sales totaled $553.3 million, bolstered by the Ames Collection, which brought $131.3 million, and Edvard Munch's *Girls on the Bridge* that sold for $54.5 million;
    - Our Frieze Week sales of Contemporary Art in London in October totaled $88.5 million, led by a $59.6 million Evening Sale that was 91% sold by lot;
    - Our June Impressionist Evening Sale totaled $151.9 million and was nearly 89% sold by lot with major works by Pablo Picasso and Amedeo Modigliani achieving $63.6 million and $56.6 million, respectively. The following week, our Contemporary Art Evening Sale totaled $69.4 million with a strong sell-through rate of 87%.
    - And last May in New York, our Impressionist, Modern & Contemporary sales totaled $484 million with works by Cy Twombly and Francis Bacon exceeding $30 million each, and records set for artists including Auguste Rodin and Sam Francis.

- Earlier this year, we united the categories of jewelry, watches, wine, cars and experiences into one Luxury & Lifestyle Division under an experienced member of Sotheby's senior management team.
    - It is an organizational structure that will help us align resources and bring greater focus to these areas. A brief update on some of the categories involved:
        - Our global wine team just completed another year where Sotheby's was the number one wine auctioneer in the world and there are a number of opportunities to grow our auction and retail businesses both online and offline that we are beginning to look at, in addition to other prospects that we see in this marketplace;
        - In jewelry, we recently opened a retail space in London dedicated to Sotheby's Diamonds;
        - We have been building out our international watch team and have made a number of important hires, including new global leadership, to complement our existing talent;
        - RM Sotheby's led the global collector car market in 2016 with auctions sales of $380 million and an annual sell-through rate of 91%. The firm's fourth annual Paris auction earlier this month realized $29.5 million, the company's most successful sale held in the city to date. The upcoming Amelia Island sale in mid-March represents the largest offering in Amelia Island auction history and includes a superlative group of Rolls-Royces, Bentleys and other sporting icons from the collection of Orin Smith.
- We also made a number of investments over the course of 2016, and these investments have gained traction in driving our future growth:
    - I am very pleased with our advisory business and we have continued to add new clients since our acquisition of *Art Agency, Partners* just over a year ago.
        - We expanded the business to include advisory services for artists and artist's estates – filling a gap that currently exists between gallerists and lawyers – and hired a leader in the growing industry of artist endowed foundations.
    - Last December we acquired *Orion Analytical*, the firm founded and operated by Jamie Martin, one of the art world's leading forensic scientists and experts in art-authentication matters, and appointed him our new Director of Scientific Research.
        - Jamie's scientific expertise and the technical capability and processes he is establishing within Sotheby's build on our existing best in class due diligence process and will help protect our clients and shareholders from forgeries;

        - In a world where collectors are rightfully concerned about authenticity, Sotheby's can use superior expertise, science, and a trusted brand to provide them with confidence.

    - In October, we announced the acquisition of The Mei Moses Art Indices, now known as *Sotheby's Mei Moses*, and we are very pleased with our investment, providing us with unique access to objective and verifiable information to complement the world-class expertise of our specialists.

<u>Now turning to the second priority</u> – to embrace technology more effectively and accelerate innovation both internally and through client-facing products:

- Improving the experience and opportunity for clients to participate with us online has been a key priority and we have made significant progress and continue to see traction in early 2017:
    - Online buyers spent $155 million at Sotheby's in 2016, up nearly 20% from the prior year, despite the overall sales decline in the art market;
    - 53% of all online bidders in 2016 were new to Sotheby's, up from 41% in 2015. This is an important metric as we continue to focus on expanding our client base.
    - Another interesting data point has to do with unsuccessful bidders in our auctions – or underbidders as we call them.
        - Underbidders are crucial to our success in the salesroom – incremental bids appear to yield an average 15-30% increase in the final selling price.
        - As we continue to see many clients choosing online as their preferred method of bidding, it's interesting to note that in 2016 we saw a 67% increase in the total number of online underbidders in our live auctions.
    - Although it is early, so far in 2017 the results are also encouraging:
        - During Americana Week, online sales were up nearly 70% compared to the prior year;
        - 40% of the bidders in our Fine Jewelry sale in New York earlier this month participated online.
- Our editorial, video and social media programs have been significant factors in engaging clients and driving online participation.
    - You may recall a data point I have referenced before that I think bears repeating – clients who engage with our editorial content are 33% more likely to bid than those who don't.

  - We are creating more content than ever before and we saw digital engagement – across all touch points including our website, apps and social channels – grow as much as 35% year-over-year, including a threefold increase in video views;
  - Visitors to Sothebys.com spend 39% longer on our site than that of our main competitor, and we continue to reach an even broader audience through our market-leading social media program – with over 1 million followers and an average weekly growth of 2.9% in recent weeks;
  - All contributing to the 57% increase in online bidders and 32% increase in online buyers that led to the overall totals for 2016 that I mentioned a moment ago.
- Following our launch of the Sotheby's Museum Network last fall, we have continued to add important museum partners and amassed a rapidly growing collection of over 300 videos.
  - Our first original series, sponsored by Huntsman, was *The Treasures of Chatsworth*, which featured one of Europe's greatest private houses and most significant art collections in 13 episodes and has more than 1.5 million views to date.
- In 2016, we also launched apps for the iPhone, iPad, Android phone, Apple TV, Amazon Fire and Samsung Smart TV and we have a similarly ambitious roll out of new features and functionality planned for 2017.
  - One example is a consignment tool that will provide for a more streamlined experience for potential consignors and we anticipate being up and running next month.
- Our focus on using technology to improve our internal systems and processes remains a constant priority as we work towards creating a seamless experience for our clients.
- This year, we are embarking on a major initiative focused on improving the key processes where our clients interact with us most, and we already took a number of important steps in 2016:
  - On the information technology front, we began to bring our operation in line with best practices and improve the flexibility, scalability, and reliability of our systems and services:
    - We migrated the vast majority of our corporate applications and data to the cloud;
    - And we implemented 24/7 tech support and proactive monitoring of our global data network, as well as checks and processes, to ensure all live and online sales are conducted with minimal or no disruption.

  - From an operational perspective:
    - We moved our catalogue production to London, improving efficiencies and achieving savings we can invest elsewhere;

    - We launched a pack-on-site service offering clients a lower cost “soft pack” shipping solution for certain types of purchases;
    - We introduced improvements for credit card payments in New York, London and Paris;
    - And in terms of our properties around the world, we completed new premises in Geneva, Mexico City and Dubai, and also made significant improvements to many of our galleries in New York.

<u>Our next priority is our people</u> – to build a talented team and the processes to sustain success and we made considerable progress in 2016.

- We added unique talent to our organization with a particular focus on technical and leadership skills, most significantly in our specialist departments, but also in the areas of finance and strategy, business development and product development.
- We also elevated a number of talented colleagues to leadership positions around the globe including, most recently, our new Chief Operating Officer, Adam Chinn, who joined us from *Art Agency, Partners* a year ago and whose leadership has significantly improved both deal making excellence and our margins.
- We realigned existing talent and made a number of key hires in the Impressionist, Modern and Contemporary fields.
- We continue to build for success in private sales:
  - We have added the perspective and sophistication of a well-regarded collector to lead our private sale efforts in Contemporary art in New York.
    - He will join us next month after nearly two decades on Wall Street, during which he established himself as a respected collector of Post-War and Contemporary Art.
    - We have appointed new leadership for our S|2 gallery in London and have a dedicated team in place.
- We filled important gaps in our regional scope, hiring talent in cities including Los Angeles, Palm Beach and Mumbai.

<u>Our fourth priority is to allocate our capital very efficiently</u>.

- Using an example, I want to take a moment to discuss auction guarantees, hedging strategies, how they function and how we use them.

    - Imagine a collector who invested in a painting several years ago and it has been hanging on his or her wall ever since. For whatever reason, they would like to raise some cash, but they don't want to sell the work if there is a risk of it going unsold at auction or being over-shopped privately.
    - Because of the insight and expertise of our talented team, we have an informed understanding of the value of the work of art and access to people who want to own it, so we can confidently offer a guarantee to the seller and hedge it on the other side.
    - And, importantly, we can charge a premium for the service of eliminating the client's risk.
    - So in short, used prudently, guarantees are good for consignors, collectors, the market overall, and investors.
    - With respect to our hedging of such guarantees, as of February 22, 2017, we had outstanding auction guarantees totaling $147.7 million and as of that date we have reduced our financial exposure with irrevocable bids totaling $89.4 million, and may yet secure more irrevocable bids in the lead up to the March sales.

- With that, I will turn it over to Mike to expand on our results and shed some light on what we might expect in 2017.

SPEAKER: Mike Goss, Chief Financial Officer

- Thank you, Tad.
- I'd like to spend my time with you this morning addressing two questions:
    - How specifically did we outperform our expectations for this quarter, and
    - What does this quarter suggest for the future of Sotheby's?
- As for the first question – how did we outperform our expectations for the quarter – we must first start with Net Sales:
    - Net Sales for the period were down 34% versus the prior period, but down only 19% if you exclude the Taubman sales from a year ago. At the time of our last call, we had expected to continue along the same path as we had been on for the first nine months of the year – which was down 24% excluding Taubman – so we basically outperformed in the salesroom by 5% or so.
    - That's not the entirety of the story, however. Even more significantly, our Auction Commission Margin rose strongly for the fourth consecutive quarter, 18.0% versus

last year’s level of 12.9%, or even more telling, versus last year’s 15.9% if you exclude the impact of the Taubman sale from last year’s figures.

- The rest of the P&L looks pretty much as we all expected: Expenses were kept in check, our tax rate was lower, and we benefitted from the impact of our stock buyback program on the number of shares outstanding.

- The net result was a 13% improvement in fourth quarter Adjusted Earnings per Share* versus the same period a year ago, despite Net Sales levels, which were 34% lower than the year ago period.

- Interestingly, these results were also achieved after giving effect to a $7.4 million loss on inventory activities, which largely reflects a writedown in the value of house inventory to reflect lower realizable values as we more aggressively seek to sell this legacy inventory in the coming year and use the resulting cash for more productive activities.

- Now for the second question: What does this quarter suggest for the future of Sotheby’s? Let’s start with the key takeaways from the year we just completed:

  - Despite market softness that led to a 29% reduction in Net Sales, our Adjusted EPS* was down only 17%.

  - We achieved this because:

    - Auction revenue was off by considerably less then Net Sales were off (only 15%), the result of better discipline on pricing, more prudent guarantee writing, and a product mix of lower priced lots.

    - At the same time, we managed to keep our expenses in check, especially with respect to compensation expense, which we’ve intentionally structured to be more variable with performance.

    - We benefitted from a much lower number of shares outstanding as a result of our more disciplined approach to capital allocation.

    - A lower tax rate also helped.

- Thematically, we hope to accomplish much of the same in 2017.

  - From a Net Sales perspective, we’re off to a good start with our Modern, Impressionist, and Contemporary consignment levels in London, but this strength will be offset somewhat when we convert those sales back to dollars at a much reduced exchange rate versus a year ago. It’s still a little early to make a call on our all-important second quarter sales in New York, but given the trends we’re seeing elsewhere, we’re certainly feeling less headwind than we were at this time last year.

- On the revenue line, we expect to continue our progress on margins, especially with our November Buyer's Premium increase working in our favor for the full year. However, we would expect to see some tempering in the rate of progress versus 2016, especially if stronger Net Sales materialize at the higher end of the market and a change in mix starts working against us.
- On the expense side, we do expect to see a modest increase in our spending from year to year, particularly as we accelerate our investments in digital marketing and other technology driven initiatives, and hopefully, in our compensation expense that varies with performance.
- Finally, from a tax rate perspective, I would expect to see a slight uptick in our tax rate as our profit mix shifts back to the US, our highest taxed region, but of course, potential tax reform is still a bit of a wildcard there.
- With respect to the balance sheet, our objective is to continue our progress in allocating capital to the maximum benefit of our shareholders. In 2017, that will take the form of more aggressive conversion of inventory to cash, and perhaps a return to our stock buyback activity, although no firm decisions have been made in that direction.

- Given this approach to managing the financial side of our business, we feel that if the market stabilizes, or even better, if the headwinds we've faced in 2016 turn to tailwinds at some point in 2017, this year will be a year in which the progress we've made against our four key priorities will be more clearly demonstrated. It's too early in the year to conclude we're at that point just yet, but we're certainly poised to take advantage of a recovery when such upturn occurs.
- We'd now like to turn the call to your questions.

* Non GAAP financial measure. See the Company's Form 10-K for the period ended December 31, 2016 for an explanation of the non-GAAP financial measures used in this earnings call, as well as reconciliations to the comparable GAAP amounts.