

Sotheby's First Quarter 2018 Earnings Call Outline

May 3, 2018

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 (non-GAAP financial measures are denoted with an asterisk (“*”) in this document). An explanation of the non-GAAP financial measures used in this earnings call, as well as reconciliations to the comparable GAAP amounts are provided in Appendix B to the first quarter 2018 earnings release as well as the Company’s Form 10-Q for the period ended March 31, 2018. 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-Q and 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 this afternoon.
- Today we are reporting a first quarter 2018 loss per share of (\$0.12) compared to (\$0.21) per share in the prior period.
- For only the sixth time in the 30 years since we went public, our Adjusted Diluted Earnings Per Share* in the first quarter of 2018 was a positive \$0.09, which is a \$0.30 improvement from an Adjusted Diluted Loss Per Share* of (\$0.21) in the first quarter of 2017.
 - The calendar of our spring Hong Kong sales resulted in \$130 million in Net Auction Sales shifting from the second to the first quarter this year.
 - Let’s take a closer look at our sales in the first quarter, as well as the sales we have held thus far in the second quarter before looking ahead to our important May auctions. I will then provide a brief update on a few of our key initiatives before turning things over to Mike review the financials in more detail.
- Even excluding the calendar shift in Hong Kong, our Aggregate Auction Sales were up 18% to \$667 million.
 - Private sales increased 70% to \$246.6 million versus a year ago, and are up 73% for the trailing six months, showing that we’re beginning to see real traction from our efforts to build our private sale capabilities.
 - As we look to continue this momentum, we have expanded the team around the world and appointed leadership for private sales within the Fine Art Division.

- We began the year with our annual Masters Week auctions of Old Master paintings, drawings and sculpture in New York, which achieved a total of \$82.5 million, nearly double the results of the same series of sales in 2017.
- Moving to London at the end of February and beginning of March, our Impressionist, Modern and Contemporary Art sales brought a total of \$398.9 million with an 83% sell-through rate.
 - The series was highlighted by a stunning portrait by Pablo Picasso that sold for \$69.2 million, leading our \$215.6 million Impressionist & Modern Art sales.
 - Our Contemporary Art sales in London totaled \$183.4 million, achieving one of the highest totals for a Contemporary Art Evening Sale at Sotheby's in London and the highest Day Sale in a decade.
 - Those auctions were immediately preceded by impressive results achieved by our Contemporary team in New York: a \$26.4 million Contemporary Curated sale, the best result since 2014, and a new benchmark for an Online-Only sale at Sotheby's with our Contemporary Art Online sale totaling \$2.2 million with over 550 registrants and an average of more than 10 bids per lot.
- In mid-March, our Asia Week sales in New York brought an overall total of \$78.4 million, a 49% improvement on the prior year.
 - The series of eleven auctions was led by a monumental scroll painting by Zhang Daqian that sold for \$6.6 million, the top lot sold at any auction house in New York that week, as well as a group of Indian and South Asian Art sales that achieved \$15 million – the highest total for a decade.
- As I mentioned earlier, our major spring auctions in Hong Kong straddled our first and second quarters.
 - Not only did we add \$130 million in Net Auction Sales into the first quarter due to the timing shift, but those auctions of Wine and Modern & Contemporary Art performed 88% better than the equivalents last year.
 - The overall results of auctions from both quarters were the second best in our more than 40 years operating in Asia with a total of \$466.5 million, a 15% increase year over year.
 - The sales included a record-breaking series of wine auctions that achieved \$29.1 million. Of the 1,758 lots offered, every single one found a buyer, for a 100% sell-through rate.
 - Our results for Modern & Contemporary Art were also strong totaling \$164 million and setting seventeen new records; and sales of Chinese Works of Art totaled \$138.1 million.

- Turning now to our important auctions this month:
 - The exhibitions for our sales of Impressionist & Modern and Contemporary Art open tomorrow in New York and we are very pleased with what our teams have assembled this season. The combined low estimate for the series is up 34% compared to the same sales last year.
 - We begin with our Impressionist & Modern Art Evening Sale on May 14th, which has a low estimate of \$327.4 million.
 - The sale is led by a spectacular masterpiece by Amedeo Modigliani from 1917 that is estimated to sell for more than \$150 million.
 - We took the innovative step of unveiling the painting through a livestream from Hong Kong that was distributed on our website, Instagram, Facebook Live, Weibo and WeChat, generating nearly a quarter of a million views.
 - We will also be offering a beautiful painting by Pablo Picasso of his ‘golden muse’ Marie-Thérèse Walter from 1932 that is estimated to sell for \$25/35 million.
 - Our Contemporary Art Evening and Day sales are estimated to bring \$354.1 million and will begin on the night of May 16th with a dedicated auction of 26 works from the collection of pioneering businessman and philanthropist Morton Mandel and his wife Barbara.
 - The group features outstanding examples by artists including Joan Miró, Mark Rothko, Roy Lichtenstein, David Smith and Donald Judd, and spans many of the most important artistic movements of the 20th century.
 - Later that evening, we will offer Jackson Pollock’s *Number 32, 1949* one of the artist’s signature drip paintings. Acquired in 1983, the work has been in the same distinguished New York private collection for over 35 years and is estimated to sell for \$30/40 million.
- Moving on to our categories outside of fine art, on the 13th and 15th of May in Geneva, we will hold our sales of Important Watches and Magnificent Jewels & Noble Jewels, respectively.
 - Our sale of Magnificent Jewels & Noble Jewels carries a low estimate of \$64.7 million, which is smaller than the sale we held one year ago. But you may recall that last May we sold a pair of earrings for a record \$57 million, which accounts for much of the difference.
 - This May, we have a number of outstanding highlights including two impressive white diamonds, each weighing over 50 carats, with a combined low estimate of more than \$15 million.

- The diamonds are both perfect according to all the criteria by which diamonds are measured, and each of them is also the second largest of its shape ever to have come to auction.
 - The sale will also include The Farnese Blue, a highly important historic blue diamond given to Elisabeth Farnese, Queen of Spain in 1715, before being passed down through four of Europe’s most important royal families, that is estimated at \$3.6/5.2 million.
- Our sale of Important Watches has a low estimate of \$5.6 million, an improvement compared to last year’s result.
 - The sale is led by an extraordinarily rare Rolex Daytona ‘Paul Newman’ wristwatch, reference 6239, with a highly-coveted “tropical” dial. Fresh to the market, having been cherished by a single owner, the watch is estimated to sell for \$208/416,000.
- While the big Evening Sales grab all of the headlines, we have exciting auctions across a number of categories and price points this spring.
 - Just today in Paris, we held a very successful Design sale that exceeded the high estimate to total \$13.9 million, and we will continue with an outstanding series of Design auctions in New York at the end of May that is expected to bring more than \$15 million.
- Moving away from sales results, I will provide a brief update on one of our key strategic initiatives – embracing technology and increasing the pace of our company’s innovation.
 - In the first quarter of 2018, 49% of Sotheby’s clients used our online bidding platform, an increase of 15 percentage points over 2017 and the first time that this method of participation has been more popular than bidding by telephone.
 - Just as our clients are changing their behavior, our work digitizing Sotheby’s continues and accelerates.
 - And as we expand our reach in this area, we maintain our focus on user experience.
 - Let’s consider a possible journey taken by someone – from first hearing about Sotheby’s to successfully purchasing a work of art.
 - Our new media programs are the most effective tool we have to reach new clients.
 - That might be through video, where first quarter views are up 12% year-over-year and our production team has just won a prestigious Webby Award for ‘Treasures from Chatsworth’, our first original series, and was nominated for two additional Webby’s in animation and virtual reality.
 - Or perhaps clients first hear about Sotheby’s through one of our social media channels; where our 1.5 million followers, the most engaged in the auction business, generate shares and retweets that reach millions more.

- Once a client's interest is piqued, and they spend time on Sothebys.com or one of our apps, they can sign up to receive personally relevant emails. Our marketing emails are now more timely and targeted so we are sending half as many, but we have seen a significant increase in their effectiveness.
- It's also worth remembering that an item might have been consigned as a result of our online estimate tool, where potential consignors can very simply request an estimate from wherever they are in the world.
 - In the first quarter of 2018, we received 16,000 estimate request submissions, nearly double the number from last quarter.
 - And, since launch, 91% of the consignors who came to us through the tool have been new to Sotheby's.
 - We recently sold a rare Ming vessel that came through the tool, from a completely new client, for \$3.1 million, an indication of the opportunity we have to optimize both demand and supply through these digital tools and initiatives.
- We continue to create opportunities for clients to engage with us whenever they wish to buy and sell.
 - In the first quarter of this year, we announced the acquisition of Viyet, the fixed price online marketplace for interior design specializing in vintage and antique furniture, decorative objects and accessories, and we launched a new ecommerce platform for our retail wine business, Sotheby's Wine.
 - We have nearly tripled the number of Online-Only auctions we are presenting compared to a year ago, and continue to see success – with an average sell-through rate of 85% and performance against low estimate of 130%.
- When a client is ready to take the step to bid, they can do what 57% of our clients chose to do in the first quarter – register online.
 - In March, we launched the first phase of an improved online registration platform to make the experience far more seamless.
- An important measure of the effectiveness of all our efforts is the percentage of online users we convert from expressing initial interest by registering for a sale, to making a purchase.
 - For the most recent quarter 20% did convert, an improvement from 18% last year.
- In closing, I want to take a moment to welcome a number of new shareholders to this call – the employees of Sotheby's!
 - In March, the Board of Directors and Senior Management were thrilled to launch a program where all eligible employees were entitled to receive restricted stock

units, or a restricted cash unit mirroring our stock for those in locations where we are unable to issue stock.

- We believe that serving clients around the world consistently and superbly is a crucial component of growing our business in the future, and extending an ownership stake to all eligible employees is a great way to achieve that objective.
 - Whenever a client is dealing with a member of the Sotheby's team, they will be dealing with an owner of our firm; someone who has the service commitment of an owner – further aligning the interests of our employees with those of our shareholders.
 - Sotheby's has three assets – superior team, great global brand, and plentiful capital – but the most important one by far is our superior team. Engaging and rewarding employees with a stock award is part of the Company's commitment to our team and a key differentiator for us as an employer.
- I will now turn it over to my colleague Mike to go through our financials before we take your questions.

SPEAKER: Mike Goss, Chief Financial Officer

- Thank you, Tad.
 - We have a lot of good news to report this afternoon, much of which could be overlooked if one starts with the overly simplistic premise that our earnings resulted exclusively from the shift in timing of our Hong Kong sales.
 - I'd like to call attention to a few of those drivers, starting with the strength of our sales and what it portends for the immediate future.
- As Tad discussed throughout his comments, we had a strong quarter from a sales perspective:
 - Net Auction Sales on a reported basis were up 46% including the schedule shift in Hong Kong. But they were still up an excellent 18% even if one excludes the Hong Kong sales from the first quarter of 2018. Investors should also look at trailing six month results to size up the health of our business, and in this regard we were up a strong 14% versus the same period a year ago, again even when excluding Hong Kong from this year's numbers.
 - Importantly, of those selling categories with significant auctions in Q1, we saw strong sales and relatively high sell-through rates across nearly all of them, so the market tailwinds we've been discussing since the second half of 2017 have continued, particularly in our Fine Art categories. In addition, we are encouraged by excellent results from our Hong Kong wine business as, in addition to being a high-margin area, this can often serve as a leading indicator of demand in Asia as well as good things to come more broadly.

- We expect to see momentum continue in this second quarter – even without the Hong Kong Sales we’ll be comparing against in last year’s second quarter.
- With respect to our Auction Commission Margin, for the quarter we reported 17.3% against 18.0% last year, and for the six month period, 17.1% against 18.0% last year. The inclusion of the big Hong Kong evening sales in this year’s numbers explains most of this change. We also saw a modest impact from our guarantee hedging strategy which has the effect of moderating our margin when expressed in percentage terms. However, this strategy is clearly important to our overall profit levels and it brings the additional benefit of offering more predictability to our earnings as well.
- On the expense side, the reported numbers are again higher, but a closer look will reveal that we’re trending in line with what we discussed on our last call:
 - First, if one excludes from Adjusted Expenses* the Agency Direct Costs, which are 100% variable with increased auction and private sale activity, the rest of our expense structure (which contains the all-important investment spending behind our growth initiatives) was up versus last year by a more modest 13% for the quarter and 15% for the trailing six month period.
 - However, if you look at these expenses on a sequential basis, and take into account that we record significantly lower Incentive Compensation expense in Q1 and therefore exclude such expense for comparative purposes, you will see that our spending level was slightly down quarter to quarter. This keeps us in line with our goal of finishing the year with a significantly lower spending increase in calendar 2018 versus calendar 2017.
- Finally, the news around our balance sheet continues to be good:
 - Our inventory level is down to \$65 million, and we know of several transactions waiting to settle in Q2 that will meaningfully reduce this number yet again by June 30.
 - Our capital position remains strong: On last quarter’s call, we estimated that we had \$325 million in excess capital, and we pointed out that our board had authorized us to buy back up to \$200 million in stock. Since that time, we have repurchased nearly 980,000 shares at an average price of approximately \$52 per share, and we still have approximately \$145 million remaining on our existing authorization.
 - Importantly, this also means we have approximately \$125 million in additional excess capital to deploy. While we look for the right opportunity, we have applied this idle cash to our revolving credit facility, against which we now have only \$65 million outstanding while we have nearly \$500 million in available borrowing base capacity should we need it or choose to use it.

- What does all of this mean for the second quarter?
 - We have previously said that we expect a good, solid year in 2018 in terms of auction sales growth, progress in private sales, stability in auction commission margin, a more moderate increase in spending, and further optimization of our balance sheet – so in most material respects, we are entering the second quarter right where we expected to be and are very much in line with our previously expressed expectation for the first half.

* Non GAAP financial measure. See the Appendix to the first quarter 2018 earnings release as well as our most recently filed 10-Q for the period ended March 31, 2018 for an explanation of the non-GAAP financial measures used in this earnings call, as well as reconciliations to the comparable GAAP amounts.