

Sotheby's First Quarter 2016 Earnings Call Outline

9 May 2016

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-Q for the period ended March 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-Q and 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 CEO

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

- I'm delighted to be here today with Sotheby's new Chief Financial Officer, Mike Goss, who joined us at the end of March. I would like to thank our esteemed director, Dennis Weibling, for so ably guiding us in that role on an interim basis since the end of last year.
- I would also like to take a moment to thank Bobby Taubman who elected to retire from the Board. Bobby brought great insight, wisdom and passion to Sotheby's over his 16 years as a director and we will miss him and the spirit of his wonderful family.
- We would also like to note the passing of our long-time director, John Angelo, earlier this year. John brought incredible energy and wisdom to Sotheby's, and we were fortunate to benefit from his leadership and financial expertise over the past eight years.
- Now let's turn to the results for this quarter. As we said on our last analyst and investor call, we generated a significant loss in this quarter, mainly attributable to two factors:
 - First, at the end of 2015, it was clear that the significant market growth experienced in 2014 and the first part of 2015 had slowed somewhat. Consequently, we experienced a 35% decrease in Net Auction sales during the quarter when compared to the exceptionally strong quarter of a year ago. This was most acutely felt in the London auctions of Impressionist, Modern and Contemporary Art in February – but it was consistent with all other signs in the marketplace for this period.
 - Second, we returned to our normal pattern of quarterly seasonality. As a reminder, the auction calendar and our business are highly seasonal, with the majority of our most significant sales occurring in the second and fourth quarters. At the same time, our expenses are more evenly spread over the year, which then generally leads to losses in the first and third quarters, and income in the second and fourth quarters.

- To underscore this more fully, over the past 25 years, we've generated a loss 22 times in the first quarter.
- Despite an overall decline in auction sales during the quarter, there were a number of bright spots, affirming that the appetite for great works of art remains unabated. For example:
 - In New York in January, we had our best Old Master results in five years and our star lot, a Baroque masterpiece by the artist Gentileschi, was purchased by the J. Paul Getty Museum in Los Angeles for a record \$30.5 million.
 - In London in February, six bidders fought for a stunning portrait by Lucian Freud, sending the final price to \$23.2 million, well above expectations. Similarly, a sculpture by Auguste Rodin set a new benchmark for the artist at auction when it sold for \$16.7 million, above the \$11 million high estimate.
 - Our Asia Week sales in New York were also solid, and I will elaborate on Asia and our recent Hong Kong sales in a moment.

YTD Second Quarter Sales

- Turning now to what we are experiencing so far in the second quarter of 2016.
- Our sales in Hong Kong in early April were much anticipated – both for the quality of works we assembled and the intelligence those results would provide about the mindset of collectors in Asia.
 - The series totaled \$405 million, exceeding our expectations and representing a 17% increase on the same sales a year ago.
 - One particular highlight was a fifty-minute bidding battle for a masterpiece by one of the most celebrated masters of Chinese Painting, Zhang Daqian, which finally sold for \$34.7 million, more than four times the high estimate of \$8.3 million and a new auction record for the artist.
 - Bidders from Greater China were active and focused on competing for works of outstanding quality they felt were priced well.
- At the end of April in London, we presented Orientalist and Middle Eastern Week – a group of five sales celebrating the history of Middle Eastern art – that realized a combined total of \$22.6 million. 70% of the 600 lots sold brought prices above their high estimates and eight new artist records were established.
- We held two important jewelry sales in April and we have additional major sales taking place in Geneva and London later this season, which I will elaborate on in a moment.
 - The sales thus far have been solid, with some outstanding prices, including \$31.8 million achieved for the *De Beers Millennium Jewel 4* in Hong Kong, but our sell-through rates have been a bit weaker than we have experienced in recent seasons.

- Overall however, the results of the jewelry auction market are in line with a year ago and we are looking forward, with cautious optimism, to our upcoming sales.

Online Engagement

- Before we turn to a preview of our upcoming sales, let me take a moment to provide updates on two important strategic initiatives: first, our push to engage with our clients and buyers online, and second, an update on the integration of *Art Agency, Partners*.
 - On past calls I have gone into detail about our digital developments, particularly our commitment to expanding and engaging our audience and how we have made progress.
 - Between our own site and our partner network of *Invaluable*, and their network of 4,000 auction houses, dealers and galleries, and *eBay* and their 145 million buyers, Sotheby's has the largest audience of online bidders anywhere in the art world.
 - We continue to reach and engage new and existing audiences through a variety of tools including our social media network, the largest and fastest growing in the marketplace; multiple distribution efforts including our Apple TV app, which has contributed to a 187% increase in our video views; and our iPhone app, which we launched in early March and was rated 4.5 stars out of 5 on the App Store. We also recently released an updated iPad app and will continue to improve both products this summer.
 - The key point is engagement – clients are spending in excess of 60% more time on our website than our nearest competitor, and we know that clients who engage with the editorial content and videos we produce are 33% more likely to register to bid.
 - As of mid-April, we have seen a 32% increase in online bidders, and a 31% increase in online buyers, leading to a 60% increase in lots sold online.
 - And we are seeing this interest and engagement across all categories – for instance, in a recent Old Master & British Paintings sale in London, 32% of all lots sold by volume went to online bidders.

Update on Art Agency, Partners

- With respect to *Art Agency, Partners*, it has been three months since the team from *AAP* joined Sotheby's and I'm pleased to report that things are going well.
 - While some employees remain dedicated to advisory services exclusively, others have expanded their roles, rather comfortably, into Sotheby's core business.
 - We are working on expanding the advisory business and have a number of potential new clients – some who have come as a result of the reputation of *Art Agency, Partners* and their principals, and others who have been introduced to the services we provide through Sotheby's specialists.
 - We have begun to take some important steps in developing a framework to expand Sotheby's private sale activities. Dedicated spaces, staff, and an incentive compensation

structure that is transparent and designed to promote collaboration, are all among the topics being strategized in this initial phase.

Upcoming Sales

- Now, let's take a look at some of our upcoming sales:
- This season in New York, we changed our schedule to offer our major auctions of Impressionist, Modern and Contemporary Art in a single week, to capitalize on the evolving taste of collectors and allow for a longer pre-sale exhibition period.
 - We made some improvements to our galleries, significantly expanding our exhibition space and updating the aesthetic, all the while spending very little capital. We are now able to show more than 900 works of art simultaneously and seamlessly integrate different categories.
 - Like our February auctions in London, and reflecting the current market conditions, this week's sales of Impressionist, Modern and Contemporary art are smaller than a year ago – down 38% at the midpoint of our expected ranges – but we are very pleased with what we have assembled.
 - The sales are well-curated, with a lower level of guarantees, and we anticipate good results.
 - Highlights from tonight's sale of Impressionist & Modern Art include two Fauve masterpieces - André Derain's 1906 view of the Thames, *Les Voiles rouges*, and Maurice de Vlaminck's 1905 landscape in Chatou, *Sous-bois*, which are estimated at \$15/20 million and \$12/18 million respectively. Also on offer is a striking Pointillist painting of Saint-Tropez by Paul Signac from 1892 – *Maisons du port, Saint-Tropez* – which is estimated at \$8/12 million.
 - And on Wednesday, the evening will be led by a stunning example of Cy Twombly's famed "Blackboard" series. The canvas was acquired by the current owner directly from the artist's studio after it was executed in 1968. The night will also feature *Two Studies for a Self-Portrait* by Francis Bacon, which carries an estimate of \$22/30 million.
- Our Magnificent Jewels and Noble Jewels sale in Geneva later this month carries a low estimate of nearly \$150 million, and features some superb gemstones and signed period jewels – all predominantly from private consignors and fresh to the market. The sale is led by the "Unique Pink", a supremely rare and exceptional Fancy Vivid Pink diamond weighing 15.38 carats, which is estimated at \$28/38 million.
- We have also been entrusted with the sale of the *Lesedi La Rona*, a 1,109-carat rough diamond, discovered in Botswana last year, which has the potential to yield the single largest top-quality polished diamond in existence. The sale will be held in London in late June.

Outlook

- On our last earnings call, we said that we didn't expect sales levels for the full year 2016 to reach the annual sales levels of 2014 or 2015, and as of right now, our view remains unchanged.
- However, as I just outlined, recently we observed a number of positive indicators, most notably our Hong Kong sale series, which was up 17% year-over-year.
- Of course our most significant data points for the second quarter kick off tonight with a number of important auctions to follow in the coming days, so the next two weeks should provide all of us with a lot of good market intelligence.
- Until then, we will remain cautiously optimistic.
- From an earnings point of view, our quarterly pattern of stronger second and fourth quarters should hold true – historically, approximately 80% of our yearly sales volume fall in the second and fourth quarters – particularly in light of the fact that our London summer evening Contemporary sale will return to the second quarter this year. In 2015, the Contemporary evening sale occurred on July 1, at the very start of the third quarter, bringing \$137 million in Net Auction Sales for that quarter.
- With that, I think it makes sense to turn things over to Mike to provide some context on the numbers from the first quarter.

SPEAKER: Mike Goss, Chief Financial officer

- Thank you, Tad.
- This morning we are reporting a first quarter Adjusted Net Loss of (\$22.3) million and Adjusted Diluted Loss per Share of (\$0.35), compared to Adjusted Net Income of \$7.4 million and Adjusted Earnings per Share of \$0.11 a year ago. The adjusted figures exclude charges related to contractual severance agreements, the voluntary separation program, CEO separation and transition costs, and restructuring charges.
- As Tad has already referenced and as our recently filed 10Q reflects, the story behind these financial results is mainly about the lower state of the art market and a return to our normal quarterly seasonal pattern, following an unusually strong first quarter in the year ago period to which we are comparing.
- In the Agency Segment, we experienced a 35% decline in Net Auction Sales, a 25% decline in Private Sales, and a loss from Inventory activities. From publicly available data, we know other players in the market have experienced similar declines in their Net Auction Sales, so clearly we all have faced a softer market for art sales in the first quarter compared to last year.
- Completely consistent with this pattern, our Agency segment gross profit was down 42%, or \$48.1 million, versus the same period a year ago. Gross profit takes into account all of our Agency commissions and fees and the associated directed costs, as well as the impact of

inventory activities, so it is highly sensitive to market conditions. Most tellingly, on a consolidated basis, our adjusted operating results* declined from quarter to quarter by \$48.4 million, thus indicating the decline in Agency Segment gross profit accounted for nearly 100% of the swing in results. In a nutshell, that is the major takeaway of this quarter: lower Agency gross profit driven by softer market conditions.

- For those who want to dig deeper into the results for this quarter, I would point you to the following:
 - On a positive note, we experienced an improvement in our Auction Commission Margin, to 15.4% from 15.0% a year ago. If you exclude the impact of the \$22.5 million in net sales from the Taubman Collection in the first quarter, the margin improvement was even greater: from 15.0% last year to 16.2% this year. While much of this improvement is attributable to a shift in mix towards higher margin sales, part of this improvement can also be attributed to greater pricing discipline.
 - Within the detail of our expense breakout, you will see a \$5.2 million increase in our Salaries and Related Expenses. Two factors account for more than 100% of this increase. First, we incurred \$6.1 million in Contractual Severance Agreement charges related to departed senior level executives in Q1, and second, we recorded \$2.2 million related to the earnout obligations arising from the recent acquisition of Art Agency Partners that GAAP requires us to record as compensation expense. To arrive at our Adjusted Operating Loss*, we are adding back the effect of the Contractual Severance Agreement charges.
 - While our Finance Segment experienced a slight decline in gross profit dollars versus last year, this was principally due to the greater leverage we have achieved with the dedicated credit facility for Sotheby's Financial Services. The most important metrics for this business – a Finance Revenue Margin of 10.0% and a trailing twelve month Return on Equity of 16.3% – illustrate the advantages of our business model and our funding structure.
- With respect to the balance sheet, the biggest story of the quarter is the progress we've made on capital allocation with the repurchase of our common stock under the \$325 million authorization discussed with you in January. You might recall that in January, we started buying shares on the open market, and then we continued buying shares through a 10b5-1 program while the trading window was closed late in the quarter through tomorrow. I'm pleased to report that since the beginning of this year, we have purchased 8.0 million shares at an average price of approximately \$24 per share for a total investment of \$193 million. This represents approximately 12% of the shares that were outstanding at year-end.
- The benefits of this buyback are twofold. First, we believe the purchase of our own stock is currently the best way to deploy cash not needed for reinvestment in the business. The second benefit is that we will now be reporting our net income over a much smaller number of shares

outstanding, and all other things being equal, we will experience significant accretion on an EPS basis as a result.

- Since we plan to continue making open market purchases once the trading window opens, we thought it best to disclose to you that we've recently been advised by an outside investor that they may make purchases of our stock (whether through the open market, privately negotiated transactions, block trades or derivative transactions) to bring their holdings to at least 10% of the shares outstanding, and that they've filed the necessary documentation under the Hart-Scott-Rodino Act that would allow them to do so. Of course, they have no obligation to purchase stock and they could decide for any reason not to do so.
- As for our overall liquidity, we closed the quarter with approximately \$414 million in cash, even after giving effect to the first quarter stock repurchases. We have been relatively cautious on guarantees as indicated by our current net guarantee exposure of \$72 million.

Conclusion

- Let me conclude by saying just how pleased I am to be here at Sotheby's and how exciting I think the prospects are for our company. Yes, we have the normal ebbs and flows of the art market to deal with – along with its pattern of quarterly seasonality – but we also have everything we need to succeed in this business in the long term, starting with the very fine people here, and I am confident we're all working on the exact right issues with the appropriate amount of urgency.
- Tad and I are now happy to address your questions.

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