Sotheby's Third Quarter 2016 Earnings Call Outline

7 November 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 September 30, 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.

<u>SPEAKER: Tad Smith, President and Chief Executive Officer</u>

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

- Underneath the seasonally weak results that we expected during the quarter, we are pleased both with some small signs that the market might stabilize and also more significant internal progress on our initiatives such that, when the market does stabilize, Sotheby's will be poised to do very well for shareholders.
- With respect to the results for the quarter, this morning we have reported an Adjusted Net Loss* of ($43.1) million and Adjusted Diluted Loss per Share* of ($0.78), which compares to ($17.9) million and ($0.26), respectively, a year ago.
- Mike Goss will go into the details later, but the impact of the seasonality of our business was further exacerbated by changes to the sale calendar relative to last year, the timing of some previously mentioned inventory transactions that favored last year's results, and some non-cash writedowns and losses on inventory that we sold.

<u>Market Outlook</u>

- Turning to the market, there are four data points that can give us a potential read on the market:
  1) Operational data in the third quarter versus the same period last year and also versus earlier in 2016;

2) The Hong Kong sales in October;
3) The London Contemporary Frieze Week sales;
4) The results of consignment-getting for the upcoming major New York sales as well as the interest level in our material and the anecdotal evidence we are hearing from clients around the world.

- Excluding last year's summer Contemporary sale in London, which took place in the third quarter of 2015, the operational statistics for this third quarter compared to the prior periods give some cause for optimism. But the quarter itself is so small and the number of sales so few, that one needs to be cautious when using this data.
    - Total hammer sales (excluding buyer's premium), were down only 8% in the third quarter compared to the third quarter of 2015, while the year-to-date total was down 26%. Although the rate of the decline slowed, the third quarter accounts for a small 7% of our overall annual sales;
    - The percentage of unsold lots in the third quarter was 19% versus 23% for the same period a year ago, and 21% year-to-date;
    - Our performance against low estimate was 114% versus 101% a year ago in the third quarter and versus 98% on a year-to-date basis;
    - The overall number of bidders and buyers was up 33% and 21% respectively over this same period, and the average number of bidders per sold lot was also up, by 15%.

- The Hong Kong sales in early October were weaker than we would have liked, but the shortfalls were concentrated in two areas – Jewelry and Chinese Works of Art.
    - Many other areas did quite well, including Modern and Contemporary Asian Art, where top quality modern works continued to command strong prices, and demand for contemporary Japanese and Chinese works was noteworthy.
    - However, the comparison to the same period a year ago, as well as all of 2016 compared to 2015 is what is most revealing about the current state of the Hong Kong and Greater China markets:
        - This October, leaving aside the luxury sectors of wine, jewelry and watches, sales of art alone were down only 7%.
        - And looking year-over-year, sales of art in Hong Kong in 2016 were actually up 3%.
        - Insofar as it reflects strength among Chinese buyers, our recent sales may bode well for our important New York auctions later this month.

- The London Contemporary Frieze Week sales were encouraging.
    - Although the consignment-getting period for the sales was more difficult, that is a bit of a lagging indicator because consignments were mainly secured during the summer months.
    - The performance of the sales themselves was positive, with an overall total of $107.8 million, above our $90.9 million high estimate and with 91% of lots sold.
    - The top lot of the week across all auction houses was Jean-Michel Basquiat's *Hannibal*, when seven bidders drove the canvas to $13.1 million, more than double the high estimate.
    - Also noteworthy was our Contemporary Day sale, which achieved $19.2 million and was 86.7% sold by lot – the strongest sell-through rate for an October Contemporary Day sale in seven years.
    - For both of these sales, the high sell-through rates may signal that the market is increasingly in a buying mood.

- Turning to the upcoming major New York sales – we feel good.
    - Our Impressionist & Modern Art Evening Sale in New York on the 14th carries a low estimate of $145.8 million, which is similar in size to the other three major sales in the category we have held this year.
        - The top lot is Edvard Munch's seminal *Girls on the Bridge* from 1902 – one of the most powerful paintings of the artist's career, which is estimated to achieve in excess of $50 million. This marks the third time we have sold this particular painting since 1996 and each time it has performed well.
        - We are also pleased to be offering property from a notable American collection, assembled over multiple generations, and led by Pablo Picasso's *The Painter and His Model* from 1963, which is estimated at $12/18 million.
    - Our Contemporary Art Evening Sale on the 17th has a low estimate of $208.6 million, which is competitively very strong for the season.
        - The sale will open with 25 works assembled by Steven and Ann Ames, noted American collectors and philanthropists, including two monumental abstract masterpieces by Gerhard Richter estimated at $20/30 million each.
        - Other highlights include Andy Warhol's *Self Portrait (Fright Wig)* from the artist's seminal 1986 series, which is estimated at $20/30 million, and Jean-Michel Basquiat's *Brother's Sausage*, a monumental frieze of six panels, which carries an estimate of $15/20 million.

Internal Progress

- Next, I am delighted with our internal progress against the key priorities we announced 18 months ago.
- At the high end of the fine art market, our market share has recovered nicely and especially in Contemporary art.
    - Our team is superb and we have done extremely well in the marketplace on both the consignment side and, most importantly, in the auction room where performance really matters.
    - Our private sales are seeing some traction, and that is particularly encouraging given that we have plenty of work still to do both within the organization and with our tools.
        - Speaking of tools, one of the fundamental pieces required to grow our private sale business is the creation of a sophisticated object database, which would allow us to be much more nimble in connecting buyers and sellers.
        - And one hidden benefit of our recent acquisition of the Mei Moses Index is its existing database of 45,000 objects that provides us with a significant foundation to that project.
    - Our art advisory business has added a number of clients and has a rich pipeline of discussions for future growth.
        - Much of our advisory work is never made public, but one recent example that we can share involved a landmark capital gift that enabled the Albright-Knox Art Gallery in Buffalo, New York to raise more than $100 million for their expansion project in less than three months.
            - The fundraising effort involved a match gift of $42.5 million from a collector who retained our subsidiary, *Art Agency, Partners* to structure and realize the gift.

- Turning to our strategy of building our middle market capabilities, we are also on the right track.
    - For example, in the third quarter, first time bidders at Sotheby's grew 61% versus a year ago, and many were concentrated in middle market sales.
- One of the keys to developing our middle market business is the effective use of new technologies, and here again, the signs are encouraging:
    - Year to date, online sales at Sotheby's have already exceeded $119 million, a 23% increase compared to 2015, which is particularly meaningful given the decline in sales volume overall.

- One in three bidders at Sotheby's bids online. Online bidding has emerged as the most popular method of participation for new clients – with 44% of all new bidders coming through our online channels.
- Most powerful is the fact that 40% of all online buyers are new to Sotheby's – so it is not just about existing clients choosing an online path to engage with us – this is about adding new clients.

- We are also developing new products to engage with both existing and new audiences:
    - In the third quarter, we launched Android and Amazon Fire TV apps, which joined our existing iPhone, iPad and Apple TV apps. We also just submitted a Samsung Smart TV App and expect approval in the coming weeks.
    - We officially launched the Sotheby's Museum Network – an online destination to discover video content created by and about the world's leading museums – and added numerous esteemed partners including: the Los Angeles County Museum of Art, the Whitney Museum of American Art, Château de Versailles, and the Peggy Guggenheim Collection in Venice.
        - Many of the world's most important collectors either have their own private museums or are benefactors of major institutions, and the Museum Network gives us meaningful opportunities to support their objectives in a way that differentiates us.
    - We recently took another important step in modernizing our information technology operation by completing phase one of moving our data systems to Amazon Web Services, a cloud-based web infrastructure service.
        - This brings our operation in line with best practices, and improves the performance, availability, flexibility, scalability, and reliability of our systems.
        - The change also lowers our risk profile and will save money as we grow.

- Finally, I am thrilled with our team. And the best example of that is to describe some coming attractions and recent successes:
    - In addition to the important Ames Collection of Contemporary Art I mentioned earlier, our team secured the private collection of David Bowie, which will be offered in London this week.
        - The collection is valued at more than $13 million and led by many of the most important British artists of the 20th century, including Henry Moore, Frank Auerbach and Damien Hirst.

    - In addition to targeting existing collectors, we continued to open up the world of Sotheby's to new audiences through engaging editorial and video content, that has been seen by millions of viewers, as well as creative events at Twitter in San Francisco and Soho House locations across the globe.
    - The public exhibition in London opened less than a week ago and has already seen more than 24,000 visitors.
  - Experimentation to broaden our networks is happening across the company in interesting and creative ways, including partnering with influencers and tastemakers on auctions:
    - The team engaged Asian pop icon, T.O.P, and renowned fashion designer, Anya Hindmarch, as guest curators on sales of Contemporary Art in Hong Kong and London, respectively.
    - In both sales, 20% of the buyers were new to Sotheby's, and final totals exceeded our pre-sale expectations.
  - Other recent sales that were particularly successful include our Asia Week sales in New York, which totaled $63.5 million, well above our pre-sale high estimate of $36 million.
    - While there were a number of strong prices, the undisputed highlight was the evening sale of *The Roy and Marilyn Papp Collection of Chinese Paintings*, where the bidding was so deep that it took more than four hours to sell just 115 paintings. The final total of $32.2 million was double the high estimate.
  - In Paris at the end of September, we presented the collection of noted tastemaker Robert de Balkany – a three-day event that totaled an outstanding $21.6 million, with a sell-through rate of 96%. The top lot was a stunning Roman cabinet that sold for $2.8 million to the Paul Getty Museum in Los Angeles.
- And speaking of the team, I am delighted to welcome our newest member of the Board of Directors, Linus Cheung.
  - Linus is a distinguished executive who spent 10 years with HongKong Telecom, including six years as Chief Executive Officer. Prior to that post, he spent 23 years at Cathay Pacific.
  - He is also a passionate collector and a longtime participant in our salesrooms around the world.
  - This addition to our Board is particularly important for three reasons: 1.) Linus has years of history with our company as a client; 2.) He hails from a crucial part of our world – Greater China – that will be the foundation of a bright future for Sotheby's; 3.) and his appointment is an important symbol of the relationships that Sotheby's is building in China, especially with the help of our largest shareholder, Taikang.

What to Expect in Coming Quarters

- We are incredibly optimistic and enthusiastic about Sotheby's prospects in the coming year and I think our investors, clients and staff should be as well. Here is what to expect:
    - I'm looking forward to our management and specialist ranks being deepened by the arrival of new key staff, including Marc Porter and Saara Pritchard, as well as others yet to be announced, who will join us beginning after the first of the New Year.
    - Furthermore, efforts to deepen our bench in underserved geographies will increase and our focus will intensify on maximizing business opportunities such as jewelry, wine, and cars.
    - Most importantly for our future, our strategic thinking will evolve from such basic questions as "what game do we want to compete in" and "how do we win consistently" to ones such as "how does Sotheby's change the game to increase dramatically the rewards to clients and shareholders over the longer term?"
- With that, let me now turn it over to Mike for a more detailed picture of the financials.

SPEAKER: Mike Goss, Chief Financial Officer

- Thank you, Tad.
- For those of you who have been following us for the past several months, you've heard me say why it makes sense to look at our results on a rolling six month basis as a means of better understanding our business. It makes particular sense when looking at our seasonally small first and third quarters, when the impact of changes in the auction schedule or one-off transactions can significantly impact our results. This approach also makes it easier to understand our cost structure, given that we recognize most of our incentive compensation in the second and fourth quarters.
- To that end, this morning we have begun a practice of posting rolling six month data to our investor relations website, and I will be referring to that data from time to time in this morning's call.
- As we highlighted on this call three months ago, third quarter results were expected to be "quite weak" due to several clearly identifiable factors, and I'd say the actual results reported this morning bore out that prediction:
    - First, our annual London Summer Contemporary Sales took place this year during the second quarter, but we are comparing ourselves in this quarter to a year in which the same sale took place in the third quarter. Thus, on a reported basis, our Net Auction Sales look as if they declined by 57% for the quarter. However, as Tad mentioned, if you remove the $197 million attributable to last year's London sales from last year's third

quarter, you see Net Auction Sales declined only 8% year over year. But given how seasonally small the third quarter always is, I suggest if you want a more meaningful read of the market, you should look at our trailing six month results and you'll see a 22% decline in Net Auction Sales, and for our trailing nine months, you'll see a 26% decline.

- The second major factor driving the unfavorable comparison to last year is the $15 million adverse swing in Inventory Activities, driven by two independent factors:
  - First, in 2015, we had a significant gain on the sale of a single painting, which accounted for the overwhelming majority of last year's $9 million gain.
  - In contrast, this year we generated losses of $6 million from unprofitable inventory sales and from write downs of inventory to be sold because we've been focused on converting our older inventory to cash in order to redeploy that cash to better uses. With this decision has come some pain, but we think this is the right way to think about capital allocation.
- On the positive side, mitigating the adverse impacts of our auction timing and inventory redeployment issues is continued improvement on the auction commission margin front. Here again, I would strongly encourage that investors look beyond this quarter's deceptively positive 21.6%, and focus instead on our rolling six month Auction Commission Margin of 16.9%, which continues to represent marked improvements over the same period a year ago. While much of this margin improvement is due to a shift in mix towards lower price bands, we believe it also reflects greater pricing discipline.
- On the expense lines, we did a reasonably good job controlling costs, with Adjusted Expenses* down 6% for the quarter and 12% lower for the rolling six months.
- With respect to taxes, once we changed our APB 23 assertion late last year and because we've seen relatively stronger results in Asia where tax rates are lowest, our tax rate decreased significantly during the quarter to 24%. This is always helpful in periods of income, but it is detrimental in periods of loss such as this one. As a result, we recognized less of an income tax benefit relative to net loss in this current third quarter compared to last year's third quarter, but for the full year, however, this lower rate will definitely help.
- And finally, another development that benefits us in profitable periods but is a disadvantage in loss periods is the impact of having a smaller share count due to our share repurchases. As of October 31st, we have 53 million shares outstanding, a 24% decrease from fifteen months ago when we had 69.5 million shares outstanding, thanks to our aggressive stock repurchase program.

- Before opening things up for Q&A, I'd like to speak to two other issues relevant to investors reviewing this morning's results.

- A significant factor in our reported GAAP earnings is related to the accounting for our acquisition of Art Agency Partners (AAP). You may recall, as part of the acquisition agreement, we agreed to make certain earn-out payments for AAP contingent on the performance of our Contemporary, Modern, and Impressionist categories against certain absolute and relative financial targets. Despite the fact that this arrangement was really part of the consideration paid for AAP, estimates of amounts due under this earn-out arrangement are, for accounting purposes, deemed to be Compensation Expense recorded in Operating Expenses over the period during which the financial performance targets are achieved. Given our year-to-date progress against these financial targets and our visibility into the upcoming November sales, accounting rules require that we recognize approximately $17 million of expense in this quarter. Because these payments can reasonably be viewed as part of the consideration paid for the acquisition of AAP and not as ongoing compensation expense, we are excluding these expenses from our Adjusted Results. We should also note that this accounting charge does not impact the four year schedule over which these payments will be made.
- The second issue I'd like to discuss is the outlook for the fourth quarter, to the extent that it is wise to do so without the benefit of the results of any of our major November sales. We believe that when one excludes the $383 million single-owner Taubman sale from the year ago period, we will likely see a lower sales level in the fourth quarter consistent with the trends we've seen during the past six and nine month periods of down 22% and 26%, respectively.
- Offsetting this lower sales level versus a year ago will be several factors working strongly in our favor: year over year positive comparisons in our Auction Commission Margin (especially given the recently introduced increase to our Buyer's Premium schedule). We've kept our operating expenses in check. We're benefitting from a more favorable tax rate. And our aggressive share repurchase program means that we'll be reporting our earnings against a much lower share count.
- The net result? We believe our fourth quarter Adjusted Earnings Per Share* can be in the range of last year's Adjusted EPS* despite the tougher market and lower sales levels.
- 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 September 30, 2016 for an explanation of the non-GAAP financial measures used in this earnings call, as well as reconciliations to the comparable GAAP amounts.