



This 3DAdvisors Report Covers:

- ✓ **Insider Trading:** Insider Trading Behavior
- ✓ **Accounting:** Quality of Earnings Issues
- Governance:** Corporate Governance Issues

Q3 Results Raise Questions; Insiders Keep Selling Sotheby's Holdings Inc. (NYSE:BID) Update

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Contact: Bob Gabele (954) 779-3974 or bgabele@3DAdvisors.com

Business Description

Sotheby's, together with its subsidiaries, operates as an auctioneer of authenticated fine art, decorative arts, and collectibles. It operates in two segments, Auction and Finance. The Auction segment offers property in approximately 70 collecting categories, including fine art, decorative arts, jewelry, and collectibles. This segment also provides various related activities, including the purchase and resale of art and other collectibles, and the brokering of private purchases and sale of art, jewelry, and collectibles. The Finance segment offers art-related finance to art collectors and dealers, and is involved in licensing activities. The company also offers online auctions. It has a retail jewelry joint venture, which offers jewels for sale throughout Asia, Europe, and North America with The Steinmetz Diamond Group. Sotheby's was founded in 1744. It was formerly known as Sotheby's Holdings, Inc. and changed its name to Sotheby's in July 2006. Sotheby's is based in Bloomfield Hills, Michigan.

Summary of 3DAdvisors Findings for BID

- ▶ **Accounting:** Q3 results deserving of careful scrutiny
- ▶ **Insider Trading:** CFO sells remainder of holdings off the recent highs
- ▶ **Accounting:** New disclosures on acquisition raise more questions
- ▶ **Accounting:** Increasing competition results in more financing risk
- ▶ **Accounting:** Building inventory another dimension of increased risk
- ▶ **Accounting:** Pick up in principal activities also continues

Discussion of 3DAdvisors Findings for BID

Upon review of recent developments at Sotheby's, including its Q3 results (period ending 09/30/06), we find further confirmation that many of our previous observations deserve continued attention. The persistence of behaviors such as aggressive financing practices, inventory buildup and further details surrounding the Noortman acquisition paint a picture of increasing risk-taking by the Company. This increasing risk profile could possibly help explain the continued aggressive holdings reductions, well off the recent highs, by CFO, **William Sheridan**, among others.

Accounting: Q3 results deserving of careful scrutiny

Third quarter results were announced Thursday, November 9, with the Company missing the consensus earnings number due to higher than anticipated expenses. The shares had begun sliding on heavy volume the day before the release, losing about 17% over the subsequent three sessions.

While Auction & Related Revenues are normally expected to be seasonally soft in Q3, they were nonetheless down 5.2% year-over-year (yoy) and would have been down 8% were it not for favorable currency translations. Of particular interest to us was that Finance Revenues increased 105% yoy, offsetting the decline in Auction revenues and boosting overall revenues 1.6% yoy, close to expectations. Expenses were higher than expected due to increases in salaries, general and administrative costs and payroll taxes due to options exercised. Management states that it expects costs related to exercised options to decrease as the number of stock options outstanding has decreased significantly and the Company has moved to a model where employees are rewarded with restricted stock rather than with stock options.

Additionally, a few other items continue to stand out in the most recent quarter's results, some of which are covered in more detail later in this update:

- **Term loans¹ to a single client remain at levels similar to 2Q.** Three term loans to a single client representing 31% of net Notes Receivable and Consignor Advances (vs. two to a single client representing 37% at end of 2Q). This line item seems to be a window into the off-balance sheet activities of the firm. With the number of arrangements and uniquely structured deals available this area might always raise questions.
- **11% of Accounts Receivable is due from a single client.** This is a new disclosure not previously stated in either the 2Q SEC Form 10-Q or the 10-K. Without public comparables it is hard to determine whether this is an area that may potentially denote risk taking.
- **Cash Flows.** Borrowing through the revolving credit facility increased significantly, up 232% over last year, as did the funding of notes receivable and consignor advances, up 41.5%. Cash used for inventory increases jumped 72% yoy. Other uses of cash in financing activities include payments on Noortman Master Paintings B.V. (NMP) debt as per the acquisition agreement and the reinstatement of a \$0.10 per share dividend.

In short, the auction industry tends to be characterized as one that is nontransparent, driven by unique transactions and arrangements and often contains volatile valuations. With Sotheby's as the only public company, comparables are difficult to come by and norms seem to be thrown out the window with every record setting auction. In the end, who can we look to? We'd suggest that the recent trading behavior of senior management continues to display a decidedly bearish tilt, potentially reflecting their expectations for future performance and/or the notion that we may be nearing the top of a very frothy art market.

¹ Term loan: Defined as a general purpose loan to a collector or dealer secured by property not presently intended for sale.

Insider Trading: CFO sells remainder of holdings off the recent highs

Selling by Sotheby's insiders has remained robust through much of this year as we have repeatedly reported on significant holdings reductions by many of the Company's key figures. Between September 13th and December 7th little has changed with regards to this picture (see Figure 1 below).

The most noteworthy of the recent activity is that of CFO **William Sheridan** (52) who we had already been monitoring due to the fact that he had cleared out of 75% of his holdings earlier this year. After Sotheby's Q3 release, which clipped over 20% from the Company's shares, he dropped 70,500 shares in the \$31 to \$32 range. In the process, he had exercised options which were not expiring until February of 2010 at the earliest. Thus Sheridan, who between 1996 and 2005 had sold just 133,500 shares, **has effectively liquidated 96% of his holdings (276,000 shares) this year and has very few options or restricted shares scheduled to vest in 2007** (see Appendix A).

Figure 1. BID Daily Closing Price, 12/01/05 through 12/08/06. Red shaded area is where 4 insiders sold 326,250 shares. Source: Reuters and BID SEC Filings.



Other notable sellers since our last report include:

- **George Bailey (52)** – Managing Director, Europe. Bailey had sold a total of 114,000 shares between 1995 and 2005. He has sold 222,774 shares this year alone, **clipping his holdings by 60%**. He will have 36,351 options and restricted shares vest in 2007, and currently holds no common stock (see Appendix A).
- **Robin Woodhead (54)** – CEO, Sotheby's Europe and Asia, Director. Like Sherman and Bailey, Woodhead has also broken personal records with his sales this year. **He had sold a total of just 44,219 between 1998 and 2005 but has dropped 179,219**

shares this year, totaling 93% of his holdings. The most notable fact here is that he adopted his third 10b5-1 plan of the year on September 13th and then liquidated the last of his vested stock options (60,000) two weeks later on September 27th and September 28th. He will have 43,540 options and restricted stock vest in 2007 and currently holds 12,169 shares of common (see Appendix A).

- **William Ruprecht (50)** – President, CEO, Director. Like Sherman, Ruprecht also sold after the post-Q3 earnings release drop in the shares. His sales this year have been measured and part of his personal 10b5-1 trading plan, under which he has been selling monthly and **has now cleared out 30% of his position this year.**

To this, we would remind clients that among other previous Sotheby's sellers who have liquidated big chunks of holdings this year is President of Financial Services, **Mitchell Zuckerman (50), who had cleared out 100% of his holdings earlier this year** (see Research Notes 09/01/06).

Accounting: New disclosures on acquisition raise more questions

As was highlighted in our full report on Sotheby's (09/15/06), Noortman Master Paintings B.V. (NMP) was acquired by the Company in June of 2006. The details surrounding the acquisition raised several questions including those of valuation, debt, broker dealer relationships and inventory. With the 2006 Q3 SEC Form 10-Q, additional details have been disclosed which continue to create an air of mystery and raise more questions for investors. On page 8 of the 10-Q, which was filed 11/09/06, when discussing the Noortman acquisition, it states:

"In addition, the Company (Sotheby's) has also in place a key man permanent disability insurance policy of \$25 million and a key man life insurance policy of \$20 million covering Mr. Noortman."

Also disclosed in the same filing:

"...in October 2006, the Company learned that Mr. Noortman has been diagnosed with cancer."

For Sotheby's to take out \$45 million (\$0.73 per share) worth of insurance for a "key man" who's company was recently acquired in exchange for the repayment of debt, inventory (whose value is still being fully evaluated) and a note payable to said "key man", causes one to continue to ask the question that was posed in our September report, "what did Sotheby's buy and why?"

Sotheby's paid \$54 million for Noortman's company in June of 2006, making the amount of the policies look like a stretch. If Noortman is worth so much to the deal, what about the art that was acquired which added \$47 million to Sotheby's inventory numbers? Sotheby's is clearly taking its time to value those art assets acquired in the NMP acquisition. To this, we remind clients that the Company is not using independent appraisers in the process, but rather its own art experts. The time elapsed between the deal and the wrap up of the art asset appraisals is testament to the fact that subjectivity is the operative word when valuing such inventory.

It would also seem that Sotheby's is going to have a difficult time collecting on insurance policies taken out on Mr. Noortman, should any assertion of a pre-existing condition be made.

Furthermore, at Sotheby's Old-Masters Auction in London that took place on December 7th it was reported that an Amsterdam scene by Jacob van Ruisdael sold for £1.7 million to dealer Robert Noortman. In the catalogue it states that the guarantees for this auction were valued at £5.8 to £8.6 million. We find ourselves wondering whether, without Noortman in the bidding picture, those guarantees would have been met.²

Several questions can be asked here. Can Sotheby's provide an objective valuation when they themselves will be present at the auction through Noortman? Why is Noortman amassing inventory at Sotheby's expense? How does Sotheby's gain when they themselves are financing Noortman thereby offsetting the auction commission and taking on inventory risk? Financial gain can only be made through the dealer but is the Old Master segment really that strong of a market call?

Sotheby's auction guarantees are off-balance sheet. At 09/30/06, the Company had outstanding auction guarantees totaling \$172.6 million of which \$19.3 million (11%) had been advanced to the seller and recorded within Notes Receivable and Consignor Advances. On November 8th, just one week later, and after Sotheby's arguably disappointing "Impressionist & Modern Art Evening" auction, outstanding auction guarantees dropped to \$87.3 million, however, \$29.8 million, or 34% of the total, had been advanced. In this auction, many of the lots guaranteed by Sotheby's sold either below the pre-sale estimates or not at all. In total, the lots guaranteed by the Company were estimated to sell at between \$92.7 and \$126 million. In reality, they sold for just \$83.7 million.

Accounting: Increasing competition results in more financing risk

Although auction revenues were down in Q3 yoy, Sotheby's saw enough increase in finance and other revenues to offset the shortfall. This speaks loudly to us. The Company finds itself competing for business through the increased emphasis on financing art dealers and collectors. In order to secure auction rights from certain sellers, Sotheby's offers consignment loans and guarantees in order to facilitate deals. Although the Company says it will make secured loans based on loan to collateral ratios of 50% or lower, it also states that "it will also lend at loan to value ratios higher than 50%. The latter practice is on the rise. As of 09/30/06, loans representing higher than 50% of collateral totaled \$45.7 million, or 24% of Net Notes Receivable and Consignor Advances. In Q2, only \$19.1 million of these lower-collateralized loans were outstanding, representing just 14% of the total.

All in, Sotheby's balance of Notes Receivable and Consignor Advances is rapidly on the rise. Totaling just \$85.3 million at 12/31/05, these items have risen 56% through 09/30/06 to \$132.9 million. In Q3 alone, these jumped 39%.

² Bloomberg.com; "Philips Family Sells \$15.6 Million of Paintings at Sotheby's", by Linda Sandler, December 7, 2006.

Sotheby's finance segment clearly continues to grow. Trends in the industry seem to indicate that ventures are being created and that the auction houses are becoming both a business partner and financial lender to dealers and collectors. As a result, one can naturally expect to see an increase in bad debt expenses and an increase in interest expense as management will need to increase its utilization of the revolving credit facility to fund the financing division. One would ask, with this growth in financing, how much risk is BID building into its balance sheet?

Accounting: Building inventory another dimension of increased risk

In our initial report we also noted that with the Noortman acquisition, Sotheby's acquired \$47 million worth of inventory, leading to a near doubling of Sotheby's inventory. Even without the acquisition, inventory levels had seen an increase of 18% through the 2Q. This trend in inventory accumulation continued in the 3Q with Sotheby's adding an additional \$19 million worth of inventory through Noortman, resulting in a 15% increase in inventory over the quarter and a 154% increase yoy. In an industry where valuations seem to be relatively volatile, and unsold works become tainted (dubbed "burnt"), it seems risky to be building such a large book of inventory. And this inventory building continues as evidenced by Noortman's bidding efforts at the recent December 7th Old Masters Auction in London.

In speaking to art auction industry insiders, we continue to hear how valuations and appraisals for works of art can be done on a variety of criteria and for a variety of reasons, including determining fair market value, for lending purposes or for insurance. However, what remains consistent is a certain element of subjectivity. Author Charlie Finch suggests in his article, "Painting the Tape" that increasing one's inventory could allow for additional financial muscle. Mr. Finch states the following [bolding is ours]:

"...one owns ten paintings (or stocks, or other financial instruments), worth around \$20,000 each and if the 11th one is bought for an inflated price, say \$100,000 for Painting X, it allows one to claim that value for each of the ten other paintings by Artist X in your portfolio, regardless of the actual demand for said paintings in the so-called market. Increased values for a basket of paintings, create a financial instrument for borrowing purposes, slicing off a percentage as a fee for taking on risk, or using the art as an instrument for swapping shares in different funds. The beauty part is that hedge behavior also has advantages on the downside, with losses offsetting gains in other speculations for tax purposes."³

Sotheby's states: "Inventory is valued at the lower of cost or management's estimate of net realizable value. This estimate is based on management's judgments about the art market in general and the value of individual items held in inventory".⁴ Nevertheless, the fact remains that inventory within the art world can be extremely volatile, potentially manipulated and often risky. Inventory levels should be watched very carefully.

³ From "Painting the Tape" by Charlie Finch, artnet Magazine November 6, 2006.

⁴ Sotheby's 2005 SEC Form 10-K, page 14.

Accounting: Pick up in principal activities also continues

Sotheby's bulging inventories have fueled increases in its Principal Activities in past periods and the trend continues. We are monitoring this since it could reflect an increase in either guarantee exposure or an increase in defaulting loans. The Company defines Principal Activities as follows:

Principal Activities—Principal Activities consists mainly of income or loss related to auction guarantees, gains or losses on sales of inventory and gains or losses related to the sales of loan collateral, as well as any decreases in the carrying value of the Company's inventory. The level of principal activities in a period is largely attributable to the success of the Company in selling property consigned in connection with auction guarantees, as well as the supply of quality property available for investment and resale and the demand by buyers for such property.⁵

For the nine months ended 09/30/06, Principal Activities totaled \$12.4 million vs. just \$2.1 million yoy. Though the rate of increase slowed during the quarter (from the first half of the year), one wonders whether or not the tenfold increase for 2006 over the prior year is a result of increased liquidation of loan collateral or an increase in the acquisition of "guaranteed" auction items which have not sold.

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⁵ SEC Form 10-Q, filed 11/09/06, page 34.



Appendix A

Option and Restricted Stock Vesting Schedules for Selected Sotheby's Holdings Inc. Insiders

Grant Date	Equity Type	Options/Shares	Strike Price (Options)	First Vesting Date	Expiration Date (Options)	Remaining Options/Shares in Series	Unvested Options/Shares in Series	Vesting Dates of Remaining Restricted Shares/Options
Susan Alexander, Executive V.P. and Worldwide Head of Human Resources. Common stock holdings: 0 shares								
02/24/00	Options	67,500	\$18.87	02/24/01	02/24/10	67,500	0	Fully Vested
09/28/01	Options	50,000	\$11.24	09/28/02	09/28/11	50,000	0	Fully Vested
08/05/03	Options	40,000	\$8.65	08/05/04	08/05/13	40,000	10,000	08/05/07
03/31/04	R. Stock	20,171	N/A	03/31/05	03/31/08	10,085	10,085	03/31/07, 03/31/08
02/07/05	R. Stock	12,000	N/A	02/07/06	02/07/09	9,000	9,000	02/07/07, 02/07/08, 02/07/09
02/10/06	R. Stock	6,477	N/A	02/10/07	02/10/10	6,477	6,477	02/10/07, 02/10/08, 02/10/09, 02/10/10
06/16/06	R. Stock	8,000	N/A	06/16/07	06/16/10	8,000	8,000	06/16/07, 06/16/08, 06/16/09, 06/16/10
George Bailey, Managing Director - Sotheby's Europe. Common stock holdings: 0 shares								
1	Options	50,000	1	1	1	50,000	0	Fully Vested
2	Options	30,000	2	2	2	30,000	0	Fully Vested
08/05/03	Options	75,000	\$8.65	08/05/04	08/05/13	18,750	18,750	08/05/07
03/31/04	R. Stock	39,682	N/A	03/31/05	03/31/08	19,841	19,841	03/31/07, 03/31/08
02/07/05	R. Stock	12,000	N/A	02/07/06	02/07/09	9,000	9,000	02/07/07, 02/07/08, 02/07/09
02/10/06	R. Stock	10,725	N/A	02/10/07	02/10/10	10,725	10,725	02/10/07, 02/10/08, 02/10/09, 02/10/10
06/16/06	R. Stock	8,000	N/A	08/16/07	08/16/10	8,000	8,000	06/16/07, 06/16/08, 06/16/09, 06/16/10
Richard Buckley, Managing Director - North America Regional Auction Division. Common stock holdings: 3,822 shares								
08/05/03	Options	40,000	\$8.65	08/05/04	08/05/13	30,000	10,000	08/05/07
03/31/04	R. Stock	7,887	N/A	03/31/05	03/31/08	3,944	3,944	03/31/07, 03/31/08
02/07/05	R. Stock	10,000	N/A	02/07/06	02/07/09	7,500	7,500	02/07/07, 02/07/08, 02/07/09
02/10/06	R. Stock	5,397	N/A	02/10/07	02/10/10	5,397	5,397	02/10/07, 02/10/08, 02/10/09, 02/10/10
06/16/06	R. Stock	8,000	N/A	06/16/07	06/16/10	8,000	8,000	06/16/07, 06/16/08, 06/16/09, 06/16/10
Donald Pillsbury, Executive V.P., Worldwide General Counsel, Secretary. Common stock holdings: 7,569 shares								
09/28/01	Options	40,000	\$11.24	09/28/02	09/28/11	20,000	0	Fully Vested
08/05/03	Options	30,000	\$8.65	08/05/04	08/05/13	30,000	7,500	08/05/07
03/31/04	R. Stock	50,000	N/A	03/31/05	03/31/08	25,000	25,000	03/31/07, 03/31/08



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William Ruprecht, President, CEO, Director. Common stock holdings: 25,178 shares								
02/24/00	Options	200,000	\$18.87	02/24/01	02/24/10	200,000	0	Fully Vested
08/05/03	Options	150,000	\$8.65	08/05/04	08/05/13	150,000	37,500	08/05/07
08/05/03	R. Stock	75,000	N/A	08/05/04	08/05/07	18,750	18,750	08/05/07
03/31/04	R. Stock	136,591	N/A	03/31/05	03/31/08	68,295	68,295	03/31/07, 03/31/08
08/05/04	Options	100,000	\$15.51	08/05/05	08/05/14	100,000	50,000	08/05/07, 08/05/08
08/05/04	R. Stock	50,000	N/A	08/05/05	08/05/08	25,000	25,000	08/05/07, 08/05/08
02/07/05	R. Stock	115,000	N/A	02/07/06	02/07/09	86,250	86,250	02/07/07, 02/07/08, 02/07/09
02/10/06	R. Stock	28,059	N/A	02/10/07	02/10/10	28,059	28,059	02/10/07, 02/10/08, 02/10/09, 02/10/10
03/31/06	R. Stock	78,785	N/A	03/31/07	03/31/10	78,785	78,785	03/31/07, 03/31/08, 03/31/09, 03/31/10
05/09/06	R. Stock	300,000	N/A	³	³	300,000	300,000	³
William Sheridan, Executive V.P., CFO. Common stock holdings: 8,992 shares								
08/05/03	Options	65,000	\$8.65	08/05/04	08/05/13	16,250	16,250	08/05/07
03/31/04	R. Stock	20,614	N/A	03/31/05	03/31/08	10,307	10,307	03/31/07, 03/31/08
02/07/05	R. Stock	20,000	N/A	02/07/06	02/07/09	15,000	15,000	02/07/07, 02/07/08, 02/07/09
02/07/06	R. Stock	15,111	N/A	02/07/07	02/07/10	15,111	15,111	02/07/07, 02/07/08, 02/07/09, 02/07/10
08/03/06	R. Stock	53,681	N/A	08/03/09	08/03/11	53,681	53,681	50% vest on 08/03/09, 50% vest on 08/03/11
Robin Woodhead, Executive V.P., Director; CEO of Sotheby's Europe and Asia. Common stock holdings: 12,169 shares								
08/05/03	Options	40,000	N/A	08/05/04	08/05/07	20,000	20,000	08/05/07
03/31/04	R. Stock	62,500	N/A	03/31/05	03/31/08	31,250	31,250	03/31/07, 03/31/08
02/07/05	R. Stock	20,000	N/A	02/07/06	02/07/09	15,000	15,000	02/07/07, 02/07/08, 02/07/09
02/10/06	R. Stock	11,658	N/A	02/10/07	02/10/10	11,658	11,658	02/10/07, 02/10/08, 02/10/09, 02/10/10
08/16/06	R. Stock	38,344	N/A	08/16/09	06/30/11	38,344	38,344	50% vest on 08/16/09, 50% vest on 06/30/11
Mitchell Zuckerman, President, Sotheby's Financial Services, Inc. and Sotheby's Ventures, LLC. Common stock holdings: 0 shares								
08/05/03	Options	40,000	N/A	08/05/04	08/05/07	10,000	10,000	08/05/07
03/31/04	R. Stock	51,561	N/A	03/31/05	03/31/08	25,780	25,780	03/31/07, 03/31/08
02/10/06	R. Stock	10,794	N/A	02/10/07	02/10/10	10,794	10,794	02/10/07, 02/10/08, 02/10/09, 02/10/10



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¹ Due to incomplete option data, we do not have information on Bailey's grant of 50,000 options issued in 2001

² Due to incomplete option data, we do not have information on Bailey's grant of 30,000 options issued in 2002

³ Ruprect's March 2006 restricted stock grant will only vest at the end of the third and fifth years of his employment arrangement, and only if certain objective performance and market-based criteria are satisfied.