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Deal of the art

It's good to be rich—everyone says so—but not necessarily good to cater to the rich. A case in point is Sotheby's, the investor-owned half of the Christie's-Sotheby's global auction-house duopoly. The oldest listed company on the New York Stock Exchange, BID is struggling when it ought to be thriving. In preview, *Grant's* is bearish on it.

"Don't be so sure" is the theme of this unfolding analysis. For instance, you may read in the papers that Sotheby's has snagged a major artwork to auction—a Van Gogh, even. You expect the news will lift the BID share price, but it doesn't—and shouldn't. And why shouldn't it? Because, as Wendy Battleson, the former head of art finance at Christie's and the founder of and principal at Art Strategy Partners LLC, explains to colleague Evan Lorenz, Sotheby's has probably given away the store to secure the picture. "It's dangerous to get big-ticket items in the door," she says.

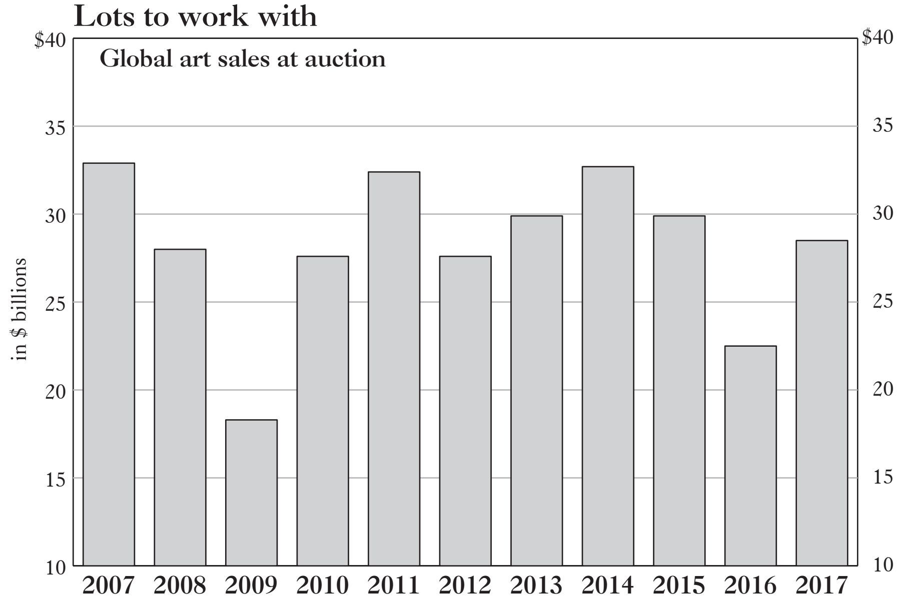
Just like Amazon.com, Inc., Sotheby's came into the world to sell books, and once upon a time it sold Napoleon's library. Not until 1913, 169 years after its founding in 1744, did the auction house make its mark in paintings. This was the sale of *Man in Black* by the 17th-century Golden Age Dutch portraitist Frans Hals; the price was a bit more than £9,000, and its price history was encouraging. From the prior sale in 1885, for £5, the picture had appreciated at a compound annual rate of 31%. In the year ended June 30, Sotheby's auctioned $6.1 billion worth of paintings and sculpture, as well as jewelry, wine and collectibles.

Auctions and private sales generate something like 70% of trailing pretax profits at Sotheby's. Financial services—e.g., loans against the collateral of a work of art—contribute 24%, and a miscellany of advisory work, brand licensing and wine retailing deliver the other 6%.

What with tiny interest rates, booming stock prices and the asset-friendly cast of international monetary policy, Sotheby's has surely had the wind at its back. Art sales worldwide rose by 11.9% in 2017, to $63.7 billion, according to the 2018 "Art Market Report" by Art Basel and UBS A.G. Dealers, of whom there are many, and auction houses, of which there are few, virtually split the business. Not that the dealer and auction communities share identical business models, or that they produce identical results. The auction market is both more volatile and more seasonal than the dealer market. The action, in auctions, is crammed into two calendar quarters, the second and fourth.

The art market is a kind of derivative of the worldwide speculative temper. Thus, prices and sales volumes retreated in 2014–16 in tandem with a weakness in commodity and share prices and a tightening of Chinese capital controls. Over that span, auction sales plummeted by 31.2% and dealer sales by 3.1%, though both roared back in 2017 with respective 26.7% and 2.3% advances in combined worldwide sales; in the first half of 2018, auction and private art sales for Sotheby's rose by 21.9%.

Lots to work with



source: 2018 "Art Market Report"

"According to 'Art Market Report,'" Lorenz relates, "Sotheby's and Christie's auctioned 19% and 23% of all art hammered down in 2017, but even those figures understate the heft of the pair. They are the go-to providers of liquidity for fine-art resales. To gain access to the most potential bidders (and thus the best price) on a Picasso or a Monet, prospective sellers, known in the trade as consignors, bring their works to the top two auction houses. Peruse any sell-side report, and you'll find pleasing references to 'duopoly' and 'pricing power.'"

"Inflation," too, figures in the bullish vocabulary. "The art market's performance has historically correlated with global GDP growth and outperformed the equity market during inflationary times," writes Cowen, Inc. analyst Oliver Chen. "Specifically in the United States, where around 39% of BID's sales are generated, the fine-art market outperformed both equities and bonds during inflationary periods between 1950 and 2017."

Besides which, boosters observe, Sotheby's has made a success of technology, with revenue from online-only auction sales growing by 30% in the first six months of this year, to reach $100 million. The Street calls BID "un-Amazon-able."

Then, there's the shareholder-friendly management team. In May 2014, following a rancorous activist campaign, hedge fund Third Point LLC obtained three seats on the Sotheby's board in exchange for a pledge not to raise its ownership in the auction house above 15%. So Dan Loeb now sits on the board alongside the Duke of Devonshire. In March 2015, Tad Smith, former president and CEO of Madison Square Garden Co., was named the Sotheby's CEO. Within three years, BID had repurchased 16.9 million shares, or 25% of shares outstanding, for a consideration of $529.3 million.

Nonetheless, the balance sheet is presentable, with $292.5 million of net debt, equivalent to 1.5 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA) and 1.8 times EBIT. First-half operating income covered interest expense by five times. The company is rated double-B-minus by Standard & Poor's, near the penthouse of junk.

"That would seem a compelling narrative despite the hefty price tag of 21.8 times estimated 2018 earnings," Lorenz observes. "Unfortunately, the story line has left the bullish analysts ill-equipped to explain Sotheby's 2018 results. In the first two quarters, auction and private sales boomed by the aforementioned 21.9%, but pretax profit for the relevant Sotheby's division registered a 16% decline."

A former senior executive from one of the major auction houses sums up the problem in an epigram: "It is a duopoly without pricing power," he tells Lorenz. "That is the thing that is hard for people to understand. They always think the prices and volume go up, we are going to clip a standard commission against ever increasing prices and volumes. They must be printing money. The auction houses don't manufacture anything. Every sale, they need to find new properties. They don't do original issues. They don't do IPOs. It is a pure secondary market."

Smith, though he's done a superb job at returning capital to the shareholders, has been less successful at expanding margins and market share. Then, again, it just might be that Sotheby's—for all the fire and fury of the activist campaign—is still not a profit-maximizing enterprise. Technically, management works for the shareholders. Practically, it works for the customers, especially the ultra-rich ones, while doing all in its power to deny consignments to Christie's. "[R]eally," Jennifer Park, vice president of investor relations at Sotheby's, tells Lorenz, "a lot of times, at the end of the day, especially with something at the uber/high end (our expertise is very strong at the very high end), a lot of times it comes down to financial terms." In fact if not in name, Sotheby's is a prestige-maximizing enterprise.

Unfortunately, the financial terms that cement friendly relationships with the big consignors are the very ones that pinch the bottom line. Such terms take the form, for instance, of a price guarantee or of an agreement to kick back a portion of the commission—an "enhanced hammer." Straightforward collateralized loans, another arrow in BID's financial-services quiver, do no damage to the bottom line but rather bolster it.

Then, again, not every wealthy consignor needs liquidity, so clients favor the margin-shrinking options. In the art market, the buyer pays the commission, known as a premium. The amount of premium charged on top of a winning bid varies by auction price as well as by location. In New York, the figures are these: 25% on top of the first $300,000 of a winning bid; 20% on top of the portion of a bid between $300,000 to $4 million; and 12.9% on top of the portion of a bid above $4 million.

Not all consignments for auction garner bids in excess of their reserve minimums, and some winning bidders default on their payments. As a result, consignors like the surety of a guarantee. What auction houses don't like is getting stuck with stale or unvendable merchandise. Guaranteed but unsold properties are how Sotheby's builds its own accidental art collection; the $51.6 million of inventory sold in the first two quarters of 2018 resulted in a loss of $3.4 million.

Hence, the prevalence of guarantees. To lay off risk, Sotheby's may contract with art dealers to enter a bid in exchange for a portion of the profit from the auction. If, for instance, a picture were expected to fetch $50 million, a guarantor might commit to pay $48 million in exchange for a fee. Two major paintings that were put to third-party guarantors, *Nu Couché (Sur le Côté Gauche)* by Amedeo Modigliani for $157.2 million and *Buste de Femme de Profil (Femme Écrivant)* by Pablo Picasso for $36 million, accounted for much of Sotheby's first-half earnings miss. According to an Aug. 6 CNBC report, Sotheby's likely had a small profit on the Modigliani while losing $6 to $7 million on the Picasso.

"People are increasingly concerned," Battleson says, "that because the market came back so quickly after 2008 and prices went crazy, so that for many of the artists, in particular postwar and contemporary, the market has flattened and probably is not going to increase for the foreseeable future. That is one of the reasons why the Warhol market has really cooled off and some of the other postwar and contemporary artists who did well four or five years ago are not super exciting.

"That said," Battleson goes on, "people still want to sell these pieces but don't want to sell them and take the market risk that everything can fall apart. They demand guarantees, and the auction houses are so competitive with each other that they will do this and they will do it even when the guarantees are relatively risky. That is where Sotheby's got burned this last season: by putting out some guarantees that were very risky."

Auction catalogues tell bidders which lots come to market with a price guarantee, but there's no such disclosure in the financial statements of Sotheby's. The guarantees in place during 2008 cost the guarantors dearly, and the auction houses hastened to drop the business. At length, they—and outside, or "third-party," guarantors—re-entered it. According to Lobus, a data-analytics provider, around half of the May auction sales at Sotheby's, Christie's and Phillips (a johnny-come-lately, founded in London in 1796) were backed by some form of price guarantee. Third parties provided 95% of those assurances.

The identity of the guarantors is typically kept secret. Among the 30 or so major dealers reported to engage in the practice are William Acquavella (Acquavella Galleries), David Nahmad, Guy Bennett (Qatar Museums) and Robert E. Mnuchin (Mnuchin Gallery and father of the Treasury secretary). Wealthy collectors, such as Steve Cohen, founder of Point72 Asset Management, have also offered guarantees.

"In its 10-Q and 10-K reports, Sotheby's is required to report contingent liabilities like guarantees outstanding at a point of time," Lorenz observes. "While this doesn't tell us a full period's activity, it is indicative of what BID is up to. Thus, on Aug. 2, 2017, Sotheby's had $17 million worth of guarantees outstanding, of which $2.7 million were ceded to third parties. On the next day, BID's book of guarantees ballooned to $194 million, of which third parties had backstopped $81.2 million."

This is a delicate matter—paying for bids, the auction houses would likely incur the displeasure of the Securities and Exchange Commission if the assets in question were stocks instead of paintings. As it is, some art buyers, objecting to the principle of price guarantees, sound like value investors in Tokyo who can't get their price because the Bank of Japan keeps buying up the stock market. Asking around, Lorenz heard unverifiable stories about guarantors demanding more than their pound of flesh from the auction houses in exchange for a commitment to bid. He heard no stories about guarantors demanding to help the auction houses to improve their profit margins.

The Sotheby's plain-vanilla art-lending business is as wholesome as you please, but rising interest rates do it no good; as of June 30, the aggregate loan-to-value ratio of the $480 million loan book was 41%, while the average interest charge was 7.2%, i.e., 500 to 600 basis points over the London interbank offered rate. The upcreep in three-month Libor, to 2.3% from 1% in 2016, has priced the marginal Sotheby's loan applicant out of the market.

"Consigners are saying," Park tells Lorenz, "'I don't know that I need to pay Libor plus 5% or 6%. I may just not have a loan on this piece or might just pay back the loan now.' Interest rates are certainly impacting us with that business. Going forward, though, we love the business, and it would be great if it could grow, but, I think, with interest rates where they are, it is going to be a harder path to having that grow as much as we would like otherwise." Since year-end 2016, the loan book has declined by 29%.

The Tax Cuts and Jobs Act of 2017 introduces another complication. Yes, the bill reduces tax rates on income, but also it raises the cost of trading art. American collectors have long made use of 1031 exchanges, in which capital gains from the sale of one property are deferred by purchasing a similar property. Such exchanges are now limited to President Trump's favorite asset class, which is not pictures. America weighs heavily in the market, accounting for 38% of BID's sales, so a slowdown in the velocity of American art-buying could hurt the Sotheby's bottom line.

China, too, figures in the corporate future. In 2017, Hong Kong and the People's Republic furnished 22% of revenue for Sotheby's. "Equally important is the impact of Asian clients felt not just in Hong Kong but in our New York, London, Paris and Geneva salesrooms," CEO Smith said on the Sotheby's Aug. 6 earnings call. "In the first half of 2018, Asian clients accounted for 28% of our Aggregate Auction Sales and purchased eight of the top 20 lots sold at Sotheby's year-to-date." Sotheby's would rue it if China's financial markets crashed or if Beijing slapped on even tougher capital controls to boost the renminbi/dollar exchange rate.

The Street projects that Sotheby's will expand adjusted EBITDA margins to 26% of sales in 2019 from 20% of sales in 2017. We grant the possibility, especially if Sotheby's stops competing with Christie's and further steps out of character by renouncing the practice of managing for the maximization of corporate prestige and customer gratitude. Besides, as Lorenz points out, the auction portion of the art market exhibits more cyclicality than even the S&P 500. BID could prove a superchanged play on a pullback in share prices.

Of the six analysts who cover BID, four rate the company a buy and none a sell. Over the past 12 months, insiders have sold 35,321 shares for $1.8 million. Perhaps the Street knows something that insiders don't—or vice versa.

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