Why Sothebys.com is a Dead Letter

(A Primer on Why the Price-fixing Scandal is but a Side Show)

By James Maroney

A good sailor keeps an eye on the horizon, no matter what the weather. But sometimes trouble, even with fair warning, can be hard to handle. According to what we read in the newspapers, Sotheby's and Christie's are now in trouble but the federal investigation into charges of price fixing is just a nasty squall. The real trouble is yet to break.

Apropos, I heard on "All Things Considered" the other day that it is necessary to mine 22 metric tons of ore in order to harvest a single, four-carat, gem-quality diamond. While this deplorable ratio probably contributes mightily to the cost of diamonds, it is presumably a fact of nature and unavoidable.

By Contrast, Sotheby's and Christie's each sell $2.25 billion worth of art and other objects per year (1999) in order to harvest a mere $52 million in net income, a profit margin of just 2%.[1] But in the art trade, the working ratio is not imposed by natural phenomena. It is the result of a venerable, centuries'-old Process Design that is tediously slow and grossly inefficient.

Process Design is how and at what cost a company adds "value" to raw material. For example, each item that comes in for auction is handled upwards of twenty-five times, many adding no value. Time-to-Market, how much time passes from receipt until a consignment is offered for sale, averages 115 days, nearly 4 months. Because auction is a batch, not a continuous production system, items received in January stand idle waiting for other items to arrive in February, March and April. Consequently, Work-in-Process, a cumulative tally of how long the hours spent processing one item are held in inventory before the item with which those hours are associated is sold, averages 238 hours.[2] While two, three or even more clients may bid on that Cézanne landscape, but one will take it; the underbidders leave to spend their money elsewhere. This Unmet Demand is analogous to a Stock-Out, or to seating a hungry family of five in your restaurant but serving only one of them.

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[1] Christie's and Sotheby's perennially divide about equally between 70-90% of the worldwide market for fine art sold at auction. Moreover, because their process designs are for all intents and purposes identical and because Christie's is now a private company, all figures used in this analysis are extracted from Sotheby's Annual Reports and are assumed to apply more or less equally to Christie's.

[2] The figures cited were observed in the American paintings departments at Sotheby's in December 1999. While the rate may be higher or lower in the other departments and may vary from year to year, for illustrative purposes that observed in American paintings is presumed here to be uniformly applicable.

These are just a few of the standards by which the efficiency of Process Design is measured. Inefficient systems entail what are called "frictions" which mean higher costs passed on in the form of higher prices for art. And higher prices constrict demand.

Sotheby's has traditionally resisted making its Process more efficient electing consistently to pass on ever higher fees to its customers. The introduction of the Buyers' Premium in 1979 was a notorious example as were the increases to the Buyers' Premium to 15% of the first $50,000 in 1993 and the now infamous increases in the fixed Sellers' Commissions in the fall of 1995. While these adjustments provided temporary relief for cash flow from operations, they entirely failed to address the root problem, namely that the Process annually at either house sells 121,000 lots below cost in order to sell just 38,400 that make any contribution to profits. Not quite as bad as mining diamonds but nothing to boast about.

And yet Sotheby's 1999 annual report begins with the statement:

> *"The year was one of the most successful in Sotheby's history…Sotheby's held its second highest single-owner evening sale ever, auctioning Impressionist and Modern works of art and other rare pieces from the collection of Mr. and Mrs. John Hay Whitney for a total of over $128 million."*

Sotheby's and Christie's have embraced the notion that the whole can be known by diverting attention to a fraction of the parts.

To this end, Sotheby's always illustrates their annual report with bright, color photographs of the few dozen works of art sold in the year above "record" prices. This practice, intended to imply market growth, has gained acceptance with the media and by extension with the public.

However, who is actually fooling whom? Every year the annual report also includes a variation on the following:

> *"In 1999, Sotheby's held 950 auctions worldwide, selling objects across 86 collecting categories. We sold approximately 160,000 lots worth an average lot price of $14,000. 76% of the total lots sold were priced below $5,000."*

This statement, which boldly contradicts the aforementioned custom, fairly begs to be analyzed. Here are some interesting observations:

If seventy-six percent of 160,000 lots sell below $5,000 and the average price is $14,000 then there must be only a tiny number of very large sales to balance out all the others. In fact, if there were 950 auctions worldwide contributing to the $2.25 billion annual gross, the value of an average auction was roughly $3 million dollars, a far cry from the $128 million Whitney sale. Truth, it would seem, is not in the outliers, the unusually large (or small) values in a data set, but in the means. That, in a nutshell, is the gross sales picture; what about the expense side?

Sotheby's annual report tells us that total expenses for the year were $388,412,000 so the average cost for one lot was $388,412,000 / 160,000 or $2,427. In 1999, a lot fetching $8,000 earned a seller's commission of 15% or $1,200 as well as a buyer's premium of 15% for an additional $1,200, together roughly $2,427. This suggests that in order to break even, a lot had to bring in excess of $8,000, which dwindles those lots making a contribution to profit down from 38,400 to 17,342, about 10% of the year's total turn. Conclusion: 90% of the lots sold at Sotheby's lose money for the house. Ninety percent!

What's more, the associated costs for selling property worth $8,000 per lot are approximately equal to those for selling property worth $2,000 or even $50,000 or $100,000. So 90% of the time spent by Sotheby's 500 experts and their support staff, is devoted to clearing rubble. It's starting to look more like diamond mining all the time.

Sorting wheat from chaff is essential in many businesses. Rubble in mining is all rock and debris that is not diamonds. For miners, some veins carry greater risks than others as the proportion of rubble to harvest mounts.

In the art business, Sotheby's and Christie's have defined rubble as property that sells below breakeven. As in mining, finding gems among the sea of rock is where the fun and the profit are.

But there is a hidden aspect of Sotheby's business plan that has a more profound impact upon earnings than the ratio of nuggets to overburden. It has to do with a concept known in the business jargon as AQL, the Acceptable Quality Level in a production run. Let's look at what the concept might mean if applied to the auction business.

Any company has some percentage of product come through that is defective. However, it is generally held as good practice that, when they buy, customers should receive good value for their money. Therefore, all companies should be certain to screen defective product before it is shipped out to consumers.[3]

This is such an important concept in today's business community that it may need a little amplification. Many companies that annually put out tens of millions of products strive for a *zero* defect rate as their realistic goal. Think, for example, what a defect rate of even 1:100,000 or 0.001% would mean to a company manufacturing parachutes. The risk to the future of the brand of failing to address this problem and correcting it would be enormous.

The example given above illustrates the main point: the problem varies in importance depending upon whose ox is gored. The consumer's risk is defined by the probability of accepting a lot that is below acceptable quality standards – in the case of parachutes, an

[3] "Product" at Sotheby's refers to the service of selling not to the goods themselves. A genuine painting by Picasso is, by this definition, defective product if it does not sell.

unqualified disaster - while the producer's risk is the probability of rejecting a lot that is at or above standards – merely a needless waste.

No one likes to pay for a service that is never delivered but at auction the risk of not being served is extreme. Risk to an art consignor at Sotheby's is defined by the likelihood that his or her lot will not sell. Consignors are generally unaware of the prevailing defect rate at auction but, presumably, he or she consigns an item for sale in the hope that it will sell. From the consignor's point of view, concerned with a single lot or two, the risk of not selling seems like a chance occurrence but it has disastrous consequences: four or five months lost and a zero return. I call that risk.

However, from the auction house's wider perspective, the chance of a certain percentage of lots in any sale selling and the other part not is a quantifiable known. Sotheby's does not choose to inform its consignors about the risk inherent in its Process because the company regularly compensates for a high defect rate by loading up the catalogue, by any other name a form of overproduction.

In classical economic theory, overproduction is defined as product that is made but never sold: it would be as if a restaurant, that could turn at most 100 covers a night consistently made dinner preparations for 150. It is important to understand the distinction between this activity and diamond mining because at auction, overproduction is analogous to the restaurant, not to the mine. Sotheby's (and Christie's) regularly process 200 or more lots for any given sale in the all but certain knowledge that some portion of production will be bought-in, or "Bi." The failure to sell of some proportion of what is offered is not a chance or incidental feature of the art auction industry; it is a massive, poorly managed waste that contributes mightily to the cost of the art that sells. The art that *you* buy.

Not your problem?

To put the magnitude of this problem into sharper focus, Sotheby's, as stated in their annual report, *sold* $2.25 billion worth of property in 1999. However, in every year, 24% of *all* production (by lots or by dollars) offered across all categories in all lot bands was defective: unsold, or bought-in.[4] That means Sotheby's actually *offered* $2.9 billion worth of property (0.76/$2.25 = $2.9) in order to *sell* $2.25 billion, a staggering difference of $713 million. Another roughly $713 million is bought-in annually at Christie's. This amounts at both houses to $1.4 *billion* of property annually that is unsold.

A defect rate of 1:4 is intolerable in any business. What business can afford to deliver dissatisfaction to 1:4 of its customers, a higher risk even than Russian roulette? Not only that, this unsold property, swept under the rug in Sotheby's annual report, never earned returns for the consignors or commissions for the house because the house collects next

[4] The figure given is the composite defect rate for the American paintings departments at Sotheby's and Christie's between 1983-2000. While the rate may be higher or lower in the other departments and vary from year to year, for illustrative purposes that observed in American paintings is presumed here to be uniformly applicable.

to nothing in so-called Bi Commissions. Worse, the company had the same sunk costs in every piece of unsold property as it had in properties that *were* sold meaning that all property, sold and unsold, was shipped in, catalogued, insured, stored, photographed, advertised, exhibited and put on the block. Had these items sold and the combined sellers' and buyers' premiums been deducted, an additional $96 million would have gone straight to their bottom line. Similarly, at Christie's another $96 million.

Now, with this nuance in mind, we recalculate the average cost of offering one lot, which we had pegged at $2,427. Since all property that comes up for sale carries equal costs whether sold or not, the average cost per lot is calculated as $388,412,000 (total expenses) divided by 210,526 (the total number of lots *offered*) which equals $1,844. Since lots that do not sell produce no revenue but do carry costs, the average gross revenue per unit of production offered, is $390,101,000/210,526 (total revenue from auction divided by total lots offered) minus $388,412,000/210,526 (total expenses divided by total lots offered) which comes to $8.02 per lot.

Here it is more simply: in 1999, Sotheby's spent $388.4 million to earn $390.1 million from "auction and related," a profit of $8.02 per lot or about $1.7 million all in.

$8.02 per lot for a gross profit of $1.7 million? And the Federal government alleges this company has cheated its customers to achieve these results?

The cost of this magnificent profligacy is initially born by the house. But at the end of the day it must be passed on to the consumer in the form of higher fees. And again, higher fees mean higher prices for art and higher prices constrict demand.

In 1997, Sotheby's announced that their flagship New York facility on York Avenue would undergo an extensive capital expansion in order to consolidate under one roof its "core business," the art auction. The building, projected to cost between $125/130,000,000, was to become "a state-of-the-art auction sales center in the year 2000 providing a cultural arts center for the city." The report goes on to say that strong financial markets had bolstered an already healthy art market, that the share price at $21 was at a seven year high and that the company had returned $43 million to shareholders through stock buy-backs and dividends.

Unfortunately, the company's per- share earnings growth was driven by an

aggressive share repurchase plan not a higher net income - flat at $40 million – or a robust Operating Income - down from $68 million to $67 million. Total expenses were up 15%, but auction sales, a yardstick by which Sotheby's always views its performance, were up from $1.5 billion to $1.8 billion or 13%. The emphasis upon profitability in the

1997 annual report obscured the fact that annual sales of $1.8 billion were but 65% of what they had been in 1989. Never mind: why not double capacity?[5]

Since coming to New York in 1964 and taking over Parke-Bernet, the company had always been cramped for space. And, because it had not been designed for the purpose, what space there was at the flagship building at 980 Madison Avenue was always poorly utilized. The decision in 1969 to move low-end property out of the headquarters into a new warehouse-style facility called "PB84" partially relieved the pressure.

Sotheby's tried again in 1979 to reduce direct overhead on the 121,000 lots of low-end property, keeping the prestigious Madison Avenue venue for the ten percent of high-end property, by moving its furniture and decorations departments entire into an expansive old warehouse building at York Avenue and 72nd Street. But no one was pleased.

The difficulty was partly in the brand and its implied meaning: to its constituency, Sotheby's had always meant "best" property. Indeed, the company's elite culture hourly selects out the rest and haughtily sends it away. Therefore, dragging a wider net for a larger haul of "common" property and then marginalizing it into warehouse facilities only underscored the misapplication of the franchise name to the operations so housed. But because these efforts created complex logistical problems, intractable, internal power struggles and because in 1982, not incidentally, the company was feeling the effects of a nasty downturn in the macroeconomy, to the accompaniment of audible groaning and gnashing of teeth, both "PB84" and 980 Madison Avenue were reluctantly bundled along with the furniture and decorations departments into the York Avenue building.[6] With that, the Perennial Dilemma unscathed came roaring once again into prominence.

But the trouble then, as now, was not lack of space but lack of supply: there simply was not more than the 17,342 lots/year that paid the bills to warrant new capacity to house the rest. In the final analysis, no matter where it was to be offered and sold, there was simply no more great property out there in the pipeline.

If, therefore, the grand, museum-quality expansion on York Avenue begun in 1997 was intended as a solution to the Perennial Dilemma, it represented a 180-degree shift away from how that problem had always been understood. In other words, instead of *halving* direct overhead for the nettlesome 90% burden, the new building would simply double it. Operating out of a cobble of disjointed warehouses on the Upper East Side and in Jersey City was certainly a nuisance and most probably inefficient. To bring everything under one roof would of course be ideal from many points of view, if only it would cash flow.

It could not. Sotheby's has always adopted a lagging capacity strategy meaning that management, instead of anticipating capacity requirements and then growing into them, waits until facilities are strained beyond tolerance and then builds what they had needed

[5] Sotheby's 1997 Annual Report, p. B-28
[6] Sotheby's Board of Directors comprised a disproportionate number of officers from the furniture and decorations departments who, though they individually and collectively made no contribution, enjoyed equal representation.

all along. Either way, a justification for new capacity must always rest upon a boost in productivity. The combined cost of one square foot of real estate, direct labor and material input must go down to improve what that cost returns in earnings, a measure known as Capacity Utilization.

But not only was volume in 1997 at Sotheby's off significantly from what it had been in the late eighties, the load profile, a cost measurement for one particular square foot of capacity, was not equal to all others: 90% of direct overhead and labor was producing below cost.

Moreover, since capacity was already poorly utilized, had the building planners received an indication that the supply of art objects for sale was somehow about to double or triple, matters would have only gotten worse. Given the profile of the core samples of raw material that had always come in that showed the ratio of gems to overburden stubbornly fixed at 17,342:210,546 or 1:12 for the past few decades, greater throughput would only have meant more rubble - greater loss. Therefore, to lean again on the mining analogy, if it were to be worked with traditional methods, only the discovery of a new, richer vein would improve productivity. Or perhaps the introduction of a new technology that might shift up the efficiency with which the legacy process pushed production through. And such a shift would have to be permanent, not temporary, to justify new capacity.

These elementary principles were readily apparent to Sotheby's in 1997 and yet in the annual report that was otherwise dedicated to the expansion project the word Internet does not appear anywhere. Could Dede Brooks have been keeping such plans under wraps?

In February 1998, Sotheby's, "standing on the threshold of great change," announced the formation of Sothebys.com a new Internet division.

She wrote:

> *"We believe that Sothebys.com and our innovative strategy for conducting auctions on the Internet will add to the dynamic of the global art and antiques market, creating great potential for Sotheby's and our dealer associates. We are committing significant resources to developing the highest level of on-line technology. This, combined with Sotheby's world-renowned name, our expertise and a guarantee of authenticity, has the possibility of creating immense value for the Company.*[7]

[7] Sotheby's 1998 Annual Report, p. 6

One can only be awed that Sotheby's decided to build an Internet strategy with one hand while increasing capacity 150% with the other. Auction was, after all, the *core* business, so to spend $130 million to bring all their disparate New York operations under one roof and another $100 million to take auctions to the Internet was, from that point of view, simply minding one's knitting.

The Internet was, of course, new to every business application but in the fine art auction business it was virtually untried. Add to that that in 1989 capacity was adequate for nearly $4 billion/year of volume. In 1997, with roughly half that amount of property in prospect, the plan to increase what space was already available was curious. The great and desperate hope must have been that the Internet would somehow validate the building, that it could finally bring a solution to that most nagging of dilemmas: high direct overhead for the 90% volume of goods sold annually below cost.

But this amounted, at best, to adopting contrary strategies or, at worst, to riding a horse in two directions at once. Even assuming for the moment that the Internet strategy could deliver as promised, to what purpose would the new capacity, only just approved, then be put? This point is important to understand: If the core business were to be relieved of the burden of handling 121,000 lots of assorted rubble because it was to be distributed on-line a-la eBay, (that little up-start considered by Sotheby's as a quaint novelty, not even a distant threat,) wouldn't it have made more sense, rather than doubling it, to simply tear the existing building down?

In all fairness, Sotheby's is not the only company to have fundamentally misunderstood what the Internet could and could not do. And, with today's hindsight and the great majority of e-commerce firms selling at fractions of their once billion dollar capitalization it is now all but obvious that some products are more suited to distribution over the net than others. The reasons for the spectacular decline of most e-commerce businesses are many and complex and of course they should cash flow. But here is the heart and soul of why they don't:

Ideally, an Internet "product" should be

- ✓ **Weightless**
- ✓ **Fungible** and
- ✓ **Scalable**.

Weightless means that the product is without physical properties such as length, height or even substance. A computer document or file is a pertinent example. A disk that holds 30 gigabytes takes up no more space than one that holds 1 GB.

Fungible means that each and every unit of production is identical to every other unit, like a pound of sugar or a Rolex watch. A ton of wheat harvested in Nebraska is, for all intents and purposes, identical to a ton of wheat harvested in Saskatchewan. Webvan.com now knows this: a bag of groceries in New York is fungible, i.e. it is identical to a bag containing the same choices in Connecticut. So far so good; but a bag of groceries is not weightless, hence the value of Webvan.com today.

And scalable means that if you can make and ship one unit of production for cost *x*, you can just as easily and at the same cost make, fulfill and ship orders for a million units. The product has, in other words, no or negligible variable costs. A news story, once written and then syndicated, is a relevant example.

Importantly, if your product can't have all three characteristics, no less than one of them is *imperative*. Pornography and music are two products that are ideal for the Internet medium because they have all three. Books, as Mr. Bezos now knows only too well, have but two of the three.

Well, you say, eBay sells antiques and collectibles on their site and they do OK don't they?

Yes; but consider this important difference in the business plans at exclusive Sotheby's and at omnivorous eBay. The household goods and collectibles offered through eBay are *functionally* fungible because collectibles are near-perfect substitutes one for another. And, insofar as the company does not handle inventory, eBay's goods are *effectively* weightless. And because there is virtually no end to the quantity of chattel in the world worth $50-100, assorted items of non-descript personal property are in limitless supply, making them, *practically speaking*, scalable. EBay's is either a clever - or a lucky - adaptation of the principle. No matter: eBay has no high-paid experts, takes possession of nothing, warrants the authenticity of nothing, catalogues, advertises, insures and illustrates nothing. To wit: eBay has on any given day about 6 million items available for sale on its site of which 700,000 are new and of which $17 million worth sell.[8]

Fine Art, on the other hand, has *none* of the three ideal qualities listed above - least of all scalability - making it a poor candidate for distribution over the Internet. Moreover, the product that Sothebys.com would strive to distribute on the Internet would not be "fine art" of the sort the franchise refers to the public imagination. Indeed, fine art that is suitable to be sold at Sotheby's qualifies precisely *because* it has none of the three essential qualities. There are, to be blunt, no goods that are simultaneously sourced in volume and rare. As if to make the point, Sotheby's has about 12,000 items for sale on its site at all times of which but $45,000,000 worth sell all year.[9]

Forty-five million is not chopped liver. But absent the Internet, that property is property that would not have been sold on Sotheby's stage on York Avenue. In other words, Sotheby's Internet initiative, if successful, would make their new real estate – or any real estate - superfluous. Even if it did not and the historical flow of prime goods could be doubled from 17,342 to 39,684, it would at least decimate capacity utilization (the

[8] "eBay Suspends Coin Seller Over Delivery Concerns," in NYT, April 18, 2001, p. C4
[9] Excluding the $8.14m paid for the Declaration of Independence that, while touted as an indication of the success of Sothebys.com offerings in general was a one-off having next to nothing to do with the Internet as a vehicle for making sales.

income produced by one square foot of real estate at cost) and along with it Return On Equity (the income produced in relation to the value of the equity the stock holders have in the business.) Capital structure, a measurement of how much money is devoted to building the plant, which must of course be informed by our old friend Process Design, would be turned on its head. This would, in turn, play havoc with the Performance Share Purchase Plan, which in lieu of salary advances, grants to experts and other personnel options exercisable upon fulfillment of certain performance criteria based upon the company's Earnings Per Share or ROE or both.[10] Employees holding the promise of future riches not yet fully vested in options would undergo a shift in morale; apathy and wholesale defections would ensue.

Too technical for you? Here's what it all boils down to:

The Internet is first and last about disintermediation – getting the middleman out and empowering customers. Because empowerment shifts information symmetry (the customers know more, Sotheby's knows less) it reduces friction (costs come down as customers have greater leverage with which to negotiate commissions and premiums). High volume and low cost are two important characteristics of an efficient market, and efficiency inevitably deflates prices.

However, at present, Sotheby's does not strive to disintermediate its legacy systems, to empower its customers, to relinquish its high margins or to sunset its profligate cost structures. On the tactical level, department personnel at Sotheby's seem oblivious to concepts of productivity. On the strategic level, management appears disinclined to alter a process that is materially the same today as it was in the nineteenth century, otherwise would they as recently as 1998 have erected a building that more than anything else reasserts the primacy of an antiquated and highly inefficient system?

Few in Sotheby's management but Mrs. Brooks understood what had already been gambled to double capacity and none including her understood what would now be risked to go on-line. So the strategy that emerged would reconfigure the company simultaneously as fish and fowl. The Internet would be, in a word, what Sotheby's is not and has never wanted or needed to be.

And so, after re-stating Net Income for 1997 from $40 million to $47 million and by re-allocating $19.1 million to various non-recurring charges and assigning another $22.5 million to other, non-recurring charges for 1998, by February 1999 Sotheby's was reporting that they had already committed $43.6 million to the Internet initiative. While the 1998 report focused mainly upon progress on the new building and, as usual, upon the many records broken during the year, auction sales advanced but slightly from $1.8 billion to $1.9 billion. Net Income inched ahead from $40 million to $45 million, representing a paltry profit margin of 2%.

By 1999, as the cost of the Internet initiative continued to grow unabated toward $100 million, Net Cash Provided by Operating Activities had shrunk dramatically from $92

[10] Sotheby's 1998 Annual Report, p. 56

million in 1998 to *negative* $2 million. That same year, an additional $35 million was raised from the issuance of common stock and an additional $10 million from the sale of warrants granting the right to purchase common stock.

At December 31, 1998 9,778,000 shares of Class B Common Stock with a weighted average value of $17.84 or $17.4 million were reserved for issuance under the 1987 Stock Option Plan. After all, the class "B" shares are only available to 27 insiders in Mr. Taubman's coterie some of whom are selected senior management. Mrs. Brooks and Mr. Taubman, it seems, were running the company as if it were a private not a publicly held company.

Comforted by a notice in the 1999 annual report reserving for itself the right to issue up to $300 million in notes under its U.S. commercial paper program, and to give EPS the appearance of steady growth, dividends of $0.10/share or $23 million were paid as usual. And, mindful that in 1999 interest paid on borrowings, net of capitalized interest, already totaled $18.7 million, or a third of Net Income, management decided that the stand-by notes, when and if issued, would not bear interest but would be issued at a discount. This tactic is window dressing pure and simple: interest paid on borrowings is interest paid on borrowings whether in periodic installments or all at once, up front. But for a company that, in good times, earns Net Income of $45 million the issuance of debt on this magnitude would, if the art market turned suddenly down, strain to breaking an already rash balance sheet. Total debt outstanding, which was about $254 million at March 31, 2001 is not expected to decline significantly in 2001. It cannot: earnings in the best years would do little more than pay interest on so large a debt.

But the report further states with evident sang-froid: "Borrowings under the Credit Agreement are determined on a pricing matrix based on the company's long-term debt rating assigned by Standard & Poor's Ratings Group and by Moody's Investor Services."[11]

These plans did not include any contingency for the Federal investigation that broke news in February. In September 2000, Sotheby's and Christie's each agreed to pay half of $412 million in cash and another $100 million in coupons to art buyers and sellers who claim that the auction houses colluded on prices and defrauded them.

In 2000, Sotheby's revenues declined about 10% to $398 million from $443 million in 1999 due, it was suggested, to lower than anticipated auction sales. Notwithstanding, in 2000, there was a 7.9% decline in lots sold and a 3.3% lower average selling price. The impact of this change was felt mostly at the top end: EBITDA (earnings before interest, taxes, depreciation and amortization) declined significantly to $2.5 million from $72 million in 1999 as a result of higher than expected costs primarily related to the company's Internet auction business.

[11] Sotheby's 1999 Annual Report, p. 42

In times gone by, dealers relied upon an old adage that the cost of quality was its own justification, that if things ever got bad, quality would hold its own.

In 1990, dealers learned the fallacy of this little inanity. Art, in addition to being non-essential, was illiquid into the bargain. Demand for it, while dependable over millennia, would not so much fall in hard times, as simply de-materialize.

The art market, like the market for many other commodities, is not an irrevocable staple of life as we had all supposed; it is cyclical. Furthermore, it is not a leading economic indicator, like housing starts, or the Purchasing Manager's Index, which give a hint of things to come but a lagging indicator. This means that by the time the turn is discerned in the art market, in the macroeconomy, it is already six months or more gone. The question in the second quarter of the year 2001, therefore, is not whether the art market is cyclical but what one will do about it.

Since Sotheby's bought Parke-Bernet in 1964, the art market has experienced four cycles, averaging 8.5 years:

- 1966-74
- 1974-82
- 1982-90
- 1990-?

A cycle typically breaks down into three phases of approximately three years each: the first phase is marked by dramatic demand stagnation and a widening spread between estimated and realized prices, both at auction as well as in the retail trade. Dealers, who are almost all debt - not equity - financed, and who, therefore, took on added obligations at the end of the previous cycle, struggle to make payments to their lenders as the value of their collateral, and their cash flow, both ebb.

A deepening of the previous situation but with a widening of asking and bid prices marks the second phase. With bargains abounding but little hope for a change in sight, sellers at auction and retail cling to high expectations in the hope of miracles. Bi rates at auction soar.

A gentle awakening of demand marks the first year of the third and final phase; the trend continues up but without discernable assiduity into the second. Then, in the third year, a buying frenzy ensues characterized by a sharp run-up in prices. As markets clear, operators, hoping to get back what they lost since the previous cycle, take on their greatest gambles and with them, more debt. The cycle catches them up at the worst moment, crashes and begins anew.

This is just where we are today.

Sotheby's has made the wrong call at the close of three of these cycles choosing to lay on, just when they should have shortened, sail. The purchase of Parke-Bernet in 1964 came just before the collapse of 1966; the expansion in 1972 into the 5th floor at 980 Madison Avenue that French & Company had previously occupied increased space by about 30% but preceded the collapse of 1974. The move in 1982 to York Avenue came just prior to the market meltdown. Only the fortuitous purchase, with Acquavella Galleries, in early 1990 of the Pierre Matisse Gallery Corporation transformed the potentially lethal slump of 1990 into a near miss.

In December 2000, the ARTnewsletter reported that Sotheby's and Christie's November Impressionist & Modern Sales were 40% bought-in. George W. Bush has warned that, in his view, the economy in the year 2001 is headed into recession. The Purchasing Managers' Index is at its lowest level in a decade. With all that looming up, with supply in the art market already tight and with buyers exhibiting the fickle temperament typical of cycle's end, the prospect for the next several years in the auction rooms looks bleak indeed.

Both Sotheby's and Christie's have already anticipated the peak by expanding capacity at a most unpropitious time: although Christie's has, for the time being demurred, Sotheby's has doubled their bet with the launch of an Internet strategy. Bernard Arnault of LVMH is actively biding to acquire talent from Sotheby's' expert departments and has just merged Phillips with de Pury & Luxembourg.

On December 22, 2000, citing costs associated with the federal and civil litigations, Moody's Investors Services cut Sotheby's credit and debt ratings to junk status. Excluding one-time items, Sotheby's recently posted an annual '00 net loss of $200 million. The company, however, again attributed the losses to charges associated with the Department of Justice investigation and related civil antitrust and shareholder litigation settlements.

Mr. Taubman would be smart to re-evaluate the value of his investment in Sotheby's[12] and sell it to a new owner because the real trouble is yet to break.

[12] "Majority Owner of Sotheby's is Weighing Sale of his Stake" in New York Times, 1/5/01, p. C11