94/02-Making a Bid for Sotheby's

With the art market finally regaining its strength, it's time to look at auction houses.

By Peter Lynch

Art may be the "window to the inner soul," but like cement or oil, it's also a commodity. It has its cycles of low prices and high prices and the occasional bubble followed by a bust. The latest bubble reached all the way to $82.5 million, the price fetched by Van Gogh's Portrait of Dr. Gachet in 1990. This, apparently, was the priciest bit of canvas ever unloaded at an auction. The art market was giddy. Soon afterward, it went into a three-year hangover.

What does art have to do with my favorite little objects of beauty-- stocks? When cement prices begin to turn up, it usually pays to own shares in cement companies. When aluminum prices begin to turn up, it usually pays to invest in Alcoa. So when Van Gogh prices turn up, I direct my attention to Sotheby's.

My idea of a great business is one that has a shortage of competitors. In America, we grow up thinking that competition is healthy, which in spelling bees, pie contests, and fund management, it is. But in such industries as airlines and computers, competition can lead to lousy earnings and multiple bankruptcies and is hazardous to human wealth. There ought to be a warning label.

Since any Tom, Dick, or Harriet can rent a room, buy a podium, hire a fast talker, and open business as an auction house, you'd figure that the auction business would be more competitive than even airlines or computers. This is not the case. Wealthy aristocrats, in particular, are very persnickety about who handles their effects. They want their auction houses to go back at least as far as their antiques. So they end up at one of two places: Sotheby's Holdings, founded in 1744, or Christie's International, founded in 1766.

These two companies, it turns out, handle 98 percent of the world's major auctions for art, antique furniture, jewelry, and other expensive items. Warren Buffett made his fortune and his reputation investing in companies that dominate their markets, from Katharine Graham's Washington Post to Rose Blumkin's furniture store in Omaha. Sotheby's and Christie's are like two Rose Blumkins, operating in 40 countries and 26 countries, respectively.

This isn't quite a monopoly, but a global duopoly is almost as good. You and I and $500 million could hire some scientists and invent a new computer chip, but we couldn't mount a serious threat against Sotheby's and Christie's. A company called Hapsburg Feldman recently tried and failed.

Sotheby's and Christie's have all the right contacts with galleries, dealers, and major museums. They employ celebrated experts in every category of fine art and collectibles, to whom curators at the major museums often turn for advice. Their representatives graze on the party circuit with the people who own expensive things. These are valuable long-term relationships that can't be manufactured more cheaply in Mexico or Taiwan.

That's not to say these two companies don't compete with each other. In its annual report, Sotheby's can't bring itself to mention Christie's by name. It refers only to "our main competitor." They fight endlessly over prestigious clients, and their rivalry is as spirited as the old Macy's versus Gimbels or Harvard versus Yale.

Last year, a resident of Paris, Hubert de Givenchy, announced he had decided to "simplify his lifestyle" by auctioning off several roomsful of bronzes, silver, rugs, and paintings from Louis XIV through the French Empire. A New York socialite reportedly tried to help Sotheby's win the Givenchy job with a clever seating arrangement. At a dinner party, she placed Givenchy next to Albert Taubman, Sotheby's chairman and principal stockholder, so the latter could schmooze the former. It didn't work. Christie's got the collection.

On the other hand, Sotheby's held the much-publicized auction of stuff from a castle belonging to Princess Gloria von Thurn und Taxis. This is not a German cab company. It's a prominent family whose tree reaches back into the Holy Roman Empire.

What makes this rivalry more amusing than damaging is that there are enough rich people to keep both auction houses very busy. Also, their squabbling over clients does not keep them from uniting on the important issue of raising prices. Late in 1992, Sotheby's upped its buyers' commission from 10 percent to 15 percent on the first $50,000 of any item purchased at its auctions. Christie's quickly followed suit. (Both houses take 10 percent of all amounts over $50,000.) If these were airlines, 15 other competitors would have forced them to lower their prices.

Even though the companies may be equally good investments, Sotheby's is located in New York and trades on the New York Stock Exchange, while London-based Christie's trades on the London Stock Exchange. That makes Sotheby's much easier to track for American investors. And being a Sotheby's shareholder myself, I follow that story more closely.

Sotheby's went public in 1977 with a small number of shares, only to be taken private again by Taubman in 1983. In spring of 1988, there was a new public offering of 11 million shares, a sizable chunk of which was supplied by Taubman. He made a lot of money on the sale, and the public ended up with a major stake in the auction house. The initial price was a split-adjusted $9 per share.

It was just before the Sotheby's IPO that artwork began to get preposterously expensive. First the Australian tycoon Alan Bond bought Van Gogh's Irises for $53 million. Then, shortly after the IPO, Picasso's Yo Picasso fetched $47.9 million. Eventually a Renoir entitled Au Moulin de la Gallette would go for $78.1 million. In the fall of 1989, Sotheby's stock peaked at the rather silly price of $37 a share, so for the initial investors, this was a four-bagger. The stock earned a record $1.96 per share.

It's in the nature of Wall Street to imagine that whenever a company sets a record for earnings, it will go on setting new ones. (This is no different from sports, where last year's winner is usually picked to repeat.) The people who paid $37 for the stock must have been looking for $2.50 in 1990 and $3-plus after that. They were unprepared for the expected: In cyclicals, a period of silly prices is followed by a period of sobriety. Sotheby's earnings dropped to 25 cents a share in 1991, and the $37 stock became a $10 stock. It's been stuck in the teens ever since.

This is unpleasant for former buyers, but it gives the rest of us a chance to own a piece of this great franchise at a reasonable price. Christie's peaked at almost $7 a share during the last bubble and has recently traded below $3.

During the decline, Sotheby's was strengthening itself. It cut its operating budget by 17.5 percent, to about $42 million. It reduced its debt from $54 million at the end of 1991 to $5 million by the end of 1992. As mentioned above, it raised the buyers' premium 50 percent. And it reduced its regular dividend.

Normally, I root for companies to increase the dividend, but not where the amount of the payout exceeds the annual earnings, as it did at Sotheby's for three years. This stock was artificially held up by the regular dividend, which, when cut last August from 15 cents per quarter to 6 cents, took away some of that support.

There are some risky elements to this business. To keep up its credibility in the art world, it must continue to employ the right experts (the recent resignation of president and CEO Michael Ainslie took Wall Street by surprise). Sotheby's may buy important artwork or furniture for its own account, hoping to resell these items at a profit; it could make a costly mistake. To attract prestigious collections to its auctions, Sotheby's sometimes offers the seller a guaranteed return. If the proceeds fall short of the guarantee, Sotheby's must make up the difference. And on the buyer's side, Sotheby's sometimes lends money to the winning bidder. When Alan Bond bought Irises, half the money he used was Sotheby's via a secured loan.

This loan caused a lot of head scratching after Bond went bankrupt and Sotheby's was left holding the Irises, which it later sold to the J. Paul Getty Museum

We can't have it both ways. If we believe sources that they recovered the difference, then of course it was resold for less.presumably for a much lower price. But sources in the company assure me that Sotheby's has recovered the balance of the loan from Bond and that the entire transaction turned out to be quite lucrative. Its finance subsidiary has become a profitable addition to the business.

So overall, this is a more attractive company than it was in 1989, selling for less than half the price while its principal commodity is showing signs of a revival. In December, Sotheby's sold 88 Picassos at an auction in New York, with most of the winning bids at the high end of the pre-auction estimates. Christie's had a successful fall season as well.

An auction buff myself, I recently attended a sale with my wife, Carolyn, at a leading local dealer in Boston. Here again, 90 percent of the paintings brought top dollar. An unsigned work, Still Life With Daffodils, was listed at $800 to $1,200 and went for $16,000. For a Sotheby's investor, this is exciting fundamental research.

There's also a growth element to this story, which adds to its appeal. The auction market itself is growing yearly at an estimated 15 percent worldwide, so Sotheby's stands to gain from that. The company has opened offices and "selling centers" in Europe, Latin America, and the Far East. In the 1980s, the Japanese traveled to auctions in New York to buy French art. Now they can attend auctions in

Japan and buy Japanese art. The Taiwanese can stay in Taiwan and buy Taiwanese art. The auction method seems to work in many cultures.

Sotheby's is also expanding its product line. Along with the furniture, antique jewelry, paintings, etc., Sotheby's is bringing many new items to the auction block: baseball cards, sports memorabilia, original sketches for Disney animated cartoons, comic books. The company now handles 70 different categories of collectibles. Through a subsidiary, it sells real estate, mostly in the seven-figure category. Its newest product? Used corporate jets.

Every decade seems to produce a different group of rich buyers who want to acquire the high-priced treasures of formerly rich sellers who need the cash (the Arabs in the 1970s, the Japanese in the 1980s). As long as there's death, divorce, changes of address, and reversals of fortune, we'll see no end to the procession of goods out of one drawing room and into another. Sotheby's will be there to collect the commissions both ways.

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