# Sotheby's.com: Giving the Van Gogh Away

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## ABSTRACT

The current revenue model of Sotheby's online auction sites does not adequately monetize the value the platforms offer both buyers and sellers. The situation is such that the average lot sold on Sothebys.com is losing money for the firm. To rectify this, Sotheby's must charge their Associate members for access to the platform, change the premium schedule of online sales to match that of live auctions, and make it a strategic initiative to push lower priced items from the live auctions to online sales to improve the company's overall profitability.

## SUMMARY

Section I covers Sotheby's history, growth, and information regarding the buying and selling process. Section II isolates the core question of the case: Is the current Internet strategy in fact profitable? Section III analyzes the comparative revenues, costs, and profitability of live versus online auctions. Section IV provides recommendations to improve the profitability of the online auction business model. Section V concludes with a summary and closing remarks.

## I. COMPANY HISTORY

Sotheby's is one of the largest and most famous auction houses in the world. Founded in 1744 in London by Samuel Baker, George Leigh, and John Sotheby, the business began as a book dealing operation. Baker purchased the libraries of aristocrats and auctioned off the books to newly rich Londoners. Famous sales at this time included the library Napoleon took with him to exile at St Helena. As the business flourished, sales expanded to prints, medals, and coins. Sotheby's did not enter the sale of fine arts, one of its most lucrative businesses today, until 1913.

To compete in the fine art market, Sotheby's purchased Parke-Bernet, then the largest fine art auction house in the United States, in 1964. It was during this time that the auction house's rivalry with Christie's, another London auction house specializing in fine art, intensified. As the fine art business grew, Sotheby's opened offices in Paris, Los Angeles, Hong Kong, and Moscow. Today, the company has 90 locations in over 40 countries. Its headquarters have since relocated from London to New York City.

Sotheby's thrives on two core competencies. As Craig Moffett, President of Sothebys.com, explains, "The quality of what we sell and our expertise makes us unique." The two values are intricately involved as all items sold by the house are covered under the Sotheby's Authenticity Guarantee.

While Sotheby's has built its reputation on the sale of multimillion dollar paintings and celebrity memorabilia, 80% of lots are sold for less than $5,000. In fact, company executives estimate that most of these smaller lots lose money for the auction house. Because each item must be inspected and appraised by highly trained specialists, costs of service are high regardless of the value of the item for sale.

Cataloguing is a major component of the sale process. Specialists examine, document, and photograph lots for physical catalogues to be distributed to potential buyers. Photographs are often expensive, especially for light-sensitive items, and owners of lots are charged $900 for quarter-page color photo placements in the catalogues. Even with such high charges, the costs of this process often offset the potential revenues from the sale.

Once lots are catalogued, they are prepared for the live auction process. Lots are presented on a stage before an audience of potential bidders. The auctioneer leads the process by managing the bidding increments and energy of the room. Many bidders enjoy the highly emotional and competitive nature of the process. However, bidders can also participate more passively via phone or by leaving their maximum bids known as "left bids."

About 30% of live auction lots are sold to phone or left bid buyers. These buyers do not have the ability to physically see or touch the lots but are willing to purchase them regardless. This inspired executive Craig Moffett to realize the potential for online auctions. Furthermore, Moffett believed that this new platform would help reach a larger market beyond Sotheby's physical locations.

Today in 2000, no other major auction house has launched an online auction service. eBay has already proven the viability of online auctions by realizing $224.7 million in revenues and $10.8 million in profits in 1999. Earlier this year in January, Edward Dolman, the CEO of Christie's, announced that Christie's would make its physical catalogues available on its website but not hold online auctions. Instead, Christie's will stream videos of its physical auctions and allow buyers to participate in these live auctions from their computers.

Over the past four months, Sotheby's has launched and operationalized two online sites capable of hosting virtual online auctions: Sothebys.com and Sothebys.Amazon.com. The latter site is a partnership with Amazon to create a platform for selling items of a hammer price (i.e., final sale price) typically under $1,000. Sotheby's focus is on its main site, Sothebys.com, which is the preferred platform for both buyers and sellers.

## II. CORE ISSUE

According to managers, the websites have been a success. By the end of the first month of operation, website sales already outpaced sales of all other fine-art related auction sites combined. However, the business model of online auctions is different from that of live auctions in several respects. Sales volume alone cannot be equated to financial success. After accounting for incremental costs and differences in revenue, are the websites in fact profitable?

## III. ANALYSIS

To evaluate the online business model, we must fully examine the components that determine its profitability.

*Revenues*

Sotheby's earns revenues from both sellers and buyers. Sellers pay a consignors' premium that is a percentage of the final hammer price (sale price). Buyers also pay a premium that is a percentage of the hammer price. The rates of some of these premiums, however, differ between the live auction and online models.

Sellers who consign their items to Sotheby's pay a premium that ranges from 2%-20% depending on the value of the sale regardless of whether they sell through a live or online auction. However, Sotheby's has also launched an Associate Program alongside its websites. This program allows verified dealers of fine arts, antiques, and collectibles to sell their wares on the Sotheby's websites. These dealers are not consigners. They sell their lots through storefronts on the websites and post the same information (catalogue entries and photographs) as consigned lots in the same format. Dealers also responsible for packing and shipping their own goods. In exchange, they pay no consignors' premium.

Buyers also pay a premium. For live auctions, the buyer's premium is 20% of the hammer price up to and including $15,000, 15% of the next $85,000, and 10% on amounts exceeding $100,000. For online auctions, the buyer's premium is a flat 10% regardless of hammer price. The average hammer price for a lot selling on Sothebys.com is currently $2,000; for Sothebys.Amazon.com, it is $600. As a result, Sotheby's generally earns half the premium online as it does from live auctions (10% compared to 20%).

**Table 1: Example of Revenue Differences**

| **Hammer Price: $2,000** | | | |
|---|---|---|---|
| | **Live Auction** | **Online - Consigned** | **Online - Associate** |
| Seller's Premium | $300 | $300 | $0 |
| Buyer's Premium | $400 | $200 | $200 |
| **Total Revenue** | **$700** | **$500** | **$200** |

Another feature of the auction process is the "buy-in" option. If the auction fails to earn a bid higher than the seller's reserve price, the lot is not sold and is 'bought in' to be returned to the seller. For live auctions, about 30% of lots are bought in. For online auctions, the rate is closer to 50%. However, online lots that are bought in can be re-auctioned almost immediately at no additional cost. For consigned lots, if the lot is unsold, Sotheby's collects a reduced 5% premium on the reserve price and a $75 handling fee from the seller. Generally, a lower buy-in rate is preferred by the house as most sellers are unlikely to re-auction, unsuccessfully, multiple times.[1]

*Costs*

Craig Moffett estimated that 100,000 consigned lots would be sold in 2000 as a result of increased sales from the websites. From this number, I will assume that 95,000 lots were sold in 1999 (this allows for around ~5% growth in 2000). Based on this estimate and the total direct costs of services from Sotheby's financial statements, the average cost per lot was $898 in 1999.[2]

The introduction of the Associates program created an opportunity for Sotheby's to significantly reduce cataloguing and storage costs because the dealers were now responsible for these services.

Despite these savings, implementing and operating the websites also incurred significant costs. Moffett estimated that incremental costs from the Internet strategy were expected to be $40 million in each of the first and second years.

As of March 2000, there were 1,000 Associates that had listed at least one lot and 500 Associates that qualified as active sellers on the websites. Active Associates posted an average of 10 lots for auction at any given time. Online auctions lasted two weeks. This meant that active Associates were posting around 260 lots per year.[3] Based on the online buy-in rate, about half of these lots would be sold. Assuming that the other 1,000 Associates will sell an average of 50 lots per year, this equates to a total of 115,000 lots sold by Associates.[4] Combined with the 50,000 consigned lots to be sold online, this is an estimated total of 165,000 lots.

Based on the $40 million annual incremental costs and this estimate of online sales volume, the average cost per lot is $242. The reality is that the cost of consigned lots will be higher than that of Associate-sold lots due to the need to store and catalogue consigned lots. To reflect this, I assume that consigned lots have variable costs of $524 and Associate lots of $120.[5]

The total incremental costs for the websites include several components: site design and maintenance, dedicated customer service lines and representatives, additional warehouse leasing for consigned lots to be sold online, and labor hours necessary to support the Associates network.

The management team has already made progress in reducing costs in customer service by providing more information online. However, these savings are likely to be offset by increasing costs necessary to support a rapidly growing Associates network. Currently, there are less than 5,000 associates enrolled in the program. Chris Jussel, senior vice president of the Associates Program, has already identified an additional 34,000 eligible associates worldwide.

*Profitability*

Combining all of these factors, we can directly compare the profitability of live versus online auctioned lots (Table 2). We see that at a $2,000 hammer price, the average sale price of lots sold on Sothebys.com, online sales are not profitable.

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[1] These buy-in fees could in theory earn more revenue for Sotheby's, but based on the actions of rational sellers, this is unlikely to be the case.

[2] Moffett also noted that lots selling at $1,250 would often lose money for the house. In light of this fact, this cost estimate (which does not include overhead, labor, etc.) appears reasonable.

[3] 52 weeks per year / 2 week auction cycles * 10 lots at a time = 260 annual lots

[4] (500 active Associates * 130 lots) + (1,000 Associates * 50 lots) = 115,000 lots

[5] Weighted based on lot volume, 30% and 70%, respectively, these costs result in a weighted average cost of $242.

**Table 2: Expected Profitability of Live Versus Online Auction Sales**

| Hammer Price: $2,000 | | | |
|---|---|---|---|
| | **Live Auction** | **Online - Consigned** | **Online - Associate** |
| Total Revenue if Sold | $700 | $500 | $200 |
| Revenue if Bought In[6] | $125 | $125 | $0 |
| Buy-in Rate | 30% | 50% | 50% |
| Expected Revenue[7] | $528 | $313 | $100 |
| Average Cost | $898 | $524 | $120 |
| **Profitability** | **($370)** | **($211)** | **($20)** |

## IV. RECOMMENDATIONS

Sotheby's is foregoing key opportunities to monetize the full value of online auctions for both sellers and buyers.

*Associates*

Dealers enjoy several benefits from joining the Associates Program:

1. Access to a functional online auction platform
2. Exposure to Sotheby's high-income and credit-checked customer base
3. Association with the Sotheby's brand

Under the current policy, Associates are not being charged for access to these benefits. As a Sotheby's executive said, rightly: "It's as if we're giving that antiques dealer on a dirt road in New Hampshire who has an eighteenth century grandfather clock a Madison Avenue address—for free."

To address this issue, Sotheby's should charge dealers a membership fee and the same premium structure as for sellers of consigned lots. An annual membership fee of $500 would generate $2.5 million from the current pool of 5,000 Associates. A full expansion to 34,000 Associates would generate $17 million in annual revenues from membership fees alone. These revenues could go toward growing a support staff for the Associates and providing training resources for dealers. Assuming a dealer sells all lots at a hammer price of $2,000 (the average sale price on Sothebys.com), the dealer would recoup the membership fee after 13 successful sales compared to consigning the same lots (see the difference in premium rates below). Considering that an active Associate is estimated to sell 130 lots annually, this is a rational and affordable membership fee for most sellers. The imposition of this fee will also help select those dealers that are committed to being active sellers and spur the average Associate to sell more lots on Sotheby's.

Associates should be required to pay a seller's premium on their lots similar to the structure in place for consigned lots. Currently the premium for consigned lots ranges from 2% to 20%, decreasing as the hammer price increases. Sotheby's can offer Associates discounted premium rates to offset the initial membership fee:

| **Hammer Price** | **Consignors' Premium** | **Associates' Premium** |
|---|---|---|
| $0-$1,999 | 20% | 18% |
| $2,000-$7,499 | 15% | 13% |
| $7,500-$99,999 | 10% | 8% |

Furthermore, Associates should also be charged a fee for unsold lots. Currently, there is no buy-in fee in place for Associates. A 5% commission on the reserve price as it is for consigned lots without the $75 handling fee is appropriate. This policy will incentivize Associates to price their lots realistically to encourage them to sell. This will also keep the website's inventory clear of undesirable lots.

*Buyers*

From the buyer's perspective, the Sotheby's websites also offer distinct benefits:

1. Access to verified dealers that might not otherwise be accessible online
2. Convenient and 24-hour auction platform (particularly useful for buyers in time zones different from the locations of live

[6] Assume the reserve price is $1,000.
[7] This is a weighted average using the buy-in rate as the probability of the lot not being sold. Amounts are rounded to the nearest dollar.

auctions)

3. Assurance under Sotheby's Authenticity Guarantee that extends to all lots sold on the websites

For all of these benefits, online buyers are actually receiving a discount on their premium. Sotheby's should be charging online buyers the same premium schedule as for live auctions instead of charging the current 10% flat rate instead.

We can see the direct impact of these policy changes on the firm's revenues and profitability.

*Revenues:*

| Hammer Price: $2,000 | | | |
|---|---|---|---|
| | **Live Auction** | **Online - Consigned** | **Online - Associate** |
| Seller's Premium | $300 | $300 | $260 |
| Buyer's Premium | $400 | $400 | $400 |
| **Total Revenue** | **$700** | **$700** | **$660** |

*Profitability:*

| Hammer Price: $2,000 | | | |
|---|---|---|---|
| | **Live Auction** | **Online - Consigned** | **Online - Associate** |
| Total Revenue if Sold | $700 | $700 | $660 |
| Revenue if Bought In | $125 | $125 | $50 |
| Buy-in Rate | 30% | 50% | 50% |
| Expected Revenue | $528 | $413 | $355 |
| Average Cost | $898 | $524 | $120 |
| Profitability | ($370) | ($111) | $235 |

The implementation of these new policies results in a 110% increase in profitability.[8]

While these are encouraging and significant results, there are still two additional strategic recommendations.

First, Sotheby's should encourage the shift of lower priced items from the live auctions to the online platform. While these lower-price lots are still unprofitable, losses are diminished. Higher-priced lots can be profitable under the live auction and online consigned models because variable costs remain unchanged:

| Hammer Price: $5,000 | | | |
|---|---|---|---|
| | **Live Auction** | **Online - Consigned** | **Online - Associate** |
| Total Revenue if Sold | $1,750 | $1,750 | $1,650 |
| Revenue if Bought In[9] | $225 | $225 | $150 |
| Buy-in Rate | 30% | 50% | 50% |
| Expected Revenue | $1,293 | $988 | $900 |
| Average Cost | $898 | $524 | $120 |
| Profitability | $395 | $464 | $780 |

Second, Sotheby's should work toward decreasing the buy-in rate for all platforms but online auctions in particular as the rate is currently higher. Sotheby's can achieve this by offering training or advisory resources to online sellers to foster best practices to move lots. The planned implementation of MySotheby's, a service that matches buyers with relevant auctions, should also help this initiative.

## V. CONCLUSION

This examination of the online auction business revealed that high sales volume does not ensure profitability. What managers regarded as a universal success was in fact an unprofitable business model. To capture the value that is currently being discounted and even given away, Sotheby's must charge both buyers and sellers the appropriate fees and premiums that reflect the value of the platform. The firm should also focus on moving lower-priced lots online and lowering buy-in rates.

[8] This is calculated by comparing changes in weighted profitability based on proportions of sales volume. Proportions are calculated from expected volume of sales: 50,000 live auctions (23%), 50,000 consigned lots (23%), 115,000 Associate lots (53%).

[9] Assume the reserve price is $3,000.