

**Financial analysis:  
Follow-up study**

**artnet AG, Berlin**

Occasion: Presentation of the third-quarter report for the nine months ended September 30, 2008

**Sector**

Internet service provider

**Internet**

www.artnet.com

**Dates**

Nine-month report not yet known

**Master data**

Stock exchange symbol

WKN - German Securities Code 690950

ISIN DE0006909500

Bloomberg AYD.ETR

Relevant stock exchanges

Xetra and Frankfurt

Trading segment

Regulated market/Prime Standard

Share price

EUR 4.81 (Xetra; November 6 11.49 am)  
52-week high EUR 11.46  
low EUR 3.54

Number of shares

5,631,067 shares (basic)

Market capitalization

EUR 27.1 million

Shareholder structure

Galerie Neuendorf AG, Berlin	26.0%
Schaeffer Immobilien GmbH, Hamburg	11.3%
Artis Capital Management LLC, San Francisco	10.4%
Robert de Rothschild	7.3%
Oliver Schmidt	5.0%
Treasury Shares	1.4%
Free Float	38.6%

2007 dividend

none

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**Important:**

Please read the legal information and the information on possible conflicts of interest at the end of this analysis.

**Analysis result**

**BUY - Current price target EUR 9.50**

In the third quarter of 2008, artnet's revenues grew by 18.7% in US dollars (the currency in which approximately 80% of its revenue is billed). The transaction platform artnet Online Auctions accounted for 3.3% of this growth. The company believes significant additional growth can be achieved once users of the transaction platform begin to utilize other areas of the site for pricing research, advertising and viewing the art market globally in the Gallery Network. To achieve this goal artnet has recruited additional auction staff and invested heavily in development of this platform over the last five quarters since Q3/2007. The downturn in the industry has nevertheless trimmed the company's revenue growth in its existing core business to 15.4%. As we had forecasted, profits consequently have declined. However, we expect profits to return to their 2007 levels in 2009. After this, depending on the success of the auction platform we expect double-digit revenue growth rates with rising profit margins.

Margins will only rise if the trend in revenue per employee is reversed. While it is slightly above the figures for Q4/2007 and Q1/2008, a lasting improvement has yet to be seen but a trend should emerge once the auction platform begins to contribute as we anticipate.

The number of members of the gallery network, artnet's top segment with a 26% revenue increase in USD, is still expanding very satisfactorily. The number of members in 2008 rose steadily in the first three quarters by a net of 271 galleries, or +14%.

artnet is not planning to increase staff in 2009 and also expects its costs to remain at 2008 levels. Profits should therefore increase if revenue rises by 10% as anticipated, adjusted for currency effects. This excludes our predicted revenue of EUR 700 thousand from auctions. The 10% growth estimate in artnet's existing business already provides for the difficult economic situation in the art market. In Q1/2009 three new revenue drivers will be available: artnet.fr, the Decorative Art database and artist indices.

In our opinion a p/e ratio of 25 is still reasonable for the valuation of artnet shares considering of artnet's strong market positioning with a monopoly in some areas and the growth, margin expectations arising from the online auctions in particular. Our DCF model indicates a fair value of EUR 9.98. This results to a fair value assessment of EUR 9.50 (25 times the anticipated profit in 2009 of EUR 0.38) compared with EUR 12.00 in our study on Q2/2008.

Analyst: Marcus Sühling (business administration graduate)  
Date of publication: November 14, 2008  
Editorial deadline: November 6, 2008

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## 1. Key events in Q3/2008

- Sustained strong revenue growth of 23% on a dollar basis in the first nine months of 2008
- Revenue up 15.4% year-on-year in Q3/2008 on a dollar basis excluding revenue from online auctions, 18.7% including online auctions
- Revenue up 26% year-on-year in gallery network, the company's largest business segment
- Advertising revenue down in Q3 due to economic factors
- Costs in Q3 remain on Q2 levels
- Headcount increased by 5 in Q3 to 134: expansion essentially completed
- Auction platform revenues up 27% quarter-on-quarter in USD
- Buyer's premium of 10% introduced in addition to artnet online auctions' 10% seller's commission
- Cash and cash equivalents in Q3 up on a euro basis but down on a dollar basis
- Cash flows from operating activities after deduction of capitalized development expenses at USD -155 thousand for Q1-Q3/2008
- French website artnet.fr is launched
- Gallery network: 2,218 members, +93 in Q3
- Price database: 12,922 subscribers, +441 in Q3
- New products to be launched in Q1/2009: Decorative Art database and artist indices

## 2. Details

### 2.1 artnet online auctions

In the third quarter of 2008 artnet online auctions revenues increased by 27% in USD to the the previous quarter. This is the second full quarter that the auction platform has been in operation since its launch in late February. The primary change in the third quarter of 2008 was the introduction of the buyer's premium of 10% on the value of sold lots. This change was effected on August 20th. This change has effectively doubled artnet's sales commission, increasing the division's contribution margin at an above-average rate after deduction of the auction's fixed costs such as the maintenance of the Internet platform, advertising, as well as acquisition, evaluation and posting lots for auction.

After buoyant sales in July with record revenues of over USD 450 thousand, including the sale of a Warhol silk-screen print for USD 130 thousand, revenues in August and September fell substantially to below USD 200 thousand. October saw auction revenue rise again to approximately USD 230 thousand which includes revenues derived from lot-listing fees of USD 25 for each lot posted.

#### Abbott Berenice

PORTFOLIO (12): "NEW York III"  
1935

artnet Online Auctions: Tuesday 7, 2008  
Selling Price: USD 36,000



Although the number of lots posted for auction is rising, the sell-through rate, i.e. the proportion of lots sold vs. the number offered, has declined from 30% to 20%. This has prompted artnet to readjust the auction period, which it had shortened to seven days, back up to 14 days. A move which is expected to boost sales.

This shows that success also depends on fine-tuning individual parameters. artnet therefore continues to regard the auctions as a beta version that is being successively refined and positioned.

As expected, the main revenue drivers were prints and photographs. The highest revenues were generated from prints and photographs by prominent artists, Andy Warhol ranking first. The market for these two genres of art is significant. Consolidating the acquisition of auction lots will probably make galleries and buyers of art more aware of artnet online auctions as an attractive, efficient market platform and generate substantial growth.

If October's positive trend continues, it is possible that our revenue forecast of EUR 323 thousand for online auctions may still be achieved. However, as a precaution we are revising our revenue forecast downwards to EUR 300 thousand for 2008, from EUR 1,050 thousand to EUR 700 thousand for 2009 and from EUR 2,240 thousand to EUR 1,200 thousand for 2010. The 2009 revenue figure is based on an estimate of average monthly auction revenues of USD 350 thousand. Since this mark was exceeded by approximately USD 100 thousand back in July, we feel that the estimate is not too overly optimistic. Although the economic downturn is impacting the art market, the minimum prices sellers require in order to sell their lots are likely to decline as a percentage based on their lower estimate. Potential buyers will consequently be able to choose from a more attractive range of products and revenues may increase. In a difficult market, consigners – usually galleries – might be more willing to use an alternative platform like artnet's Online Auctions to shift stock and acquire additional clients.

On the whole, future success seems sustainable, albeit modest, for artnet's online art auction platform. In a few years, high-priced lots comprising paintings and sculptures might enhance the graphic arts and photography segments and generate sizeable revenues for artnet.

## 2.2 Development of the company

Revenue grew by 15.4% in Q3 in USD excluding the online auctions segment. Including online auctions, revenue was up 18.7%. The gallery network, which generates the highest revenues, experienced particularly strong growth of 26.0%. The economic slump was most apparent in the area of advertising revenues, which decreased by 5.6% measured in US dollars.

Prices in the two important segments gallery network and price information developed as follows:

While average monthly revenue per member gallery succeeded in sustaining its high level in the last quarter at USD 303, revenue per price database subscription fell to USD 43, with smaller new subscriptions tending to be bought.

The number of member galleries rose by an annual rate of approximately 19%, while price database subscriptions increased by around 16%.

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For the first time, the cost of sales and operating expenses did not rise compared with the previous quarter but fell USD 98 thousand after adjustment for the costs of the stock options. The company nevertheless further increased its headcount in the third quarter by five employees and consultants to 134. As a consequence, employee revenue per month fell to USD 11.3 thousand from USD 13.5 thousand in the previous year and USD 12.1 thousand in the previous quarter. While these investments have not yielded an immediate positive impact on earnings, we anticipate that they will support longer-term earnings growth.

2.3 Outlook

We predict an increase in revenue in USD for Q4 and 2009 of +10%, excluding revenue from online auctions. We are forecasting an average dollar/euro exchange rate of 1.30 in Q4 and 1.35 in 2009. The current strength of the dollar against the euro is also likely to be caused by temporary effects and could therefore weaken again. This would invert the negative currency effect of Q3/2008, causing revenues increasing at a faster rate in euros than in dollars.

As outlined in 2.1, we are forecasting revenue from online auctions of EUR 139 thousand in Q4, EUR 700 thousand in 2009 and EUR 1,200 thousand in 2010.

In the "cost of sales" and "operating expenses" cost items, in which we now combine all three groups of operating costs, we expect only moderate increases. This is due to the fact that the expansion of the workforce is supposed to have been largely completed. The additional employees and consultants, who increased the headcount by around 50%, now have to be integrated. Statements made by the Management Board in past annual reports on the rationalization of processes and cost-cutting could then take effect.

Table 1

artnet AG Forecast (consolidated income statement)									
Amounts in EUR thousand	2006		2007		2008		2009		2010
	Current	Change in %	Current	Change in %	Forecast	Change in %	Forecast	Change in %	Forecast
Revenues (excl. auctions)	8,416	+30.7%	11,000	+10.9%	12,200	+18.0%	14,400	+20.0%	17,280
Online auction commission					300		700		1,200
Total sales	8,416	+30.7%	11,000	+13.6%	12,500	+20.8%	15,100	+22.4%	18,480
Cost of sales	1,719	+20.6%	2,073	+133.0%	4,830	+8.0%	5,220	+10.0%	5,742
Gross profit on sales	6,697	+33.3%	8,927	-14.0%	7,670	+28.8%	9,880	+28.9%	12,738
Operating expenses	4,821	+44.8%	6,980	+0.2%	7,000	+12.1%	7,850	+12.1%	8,800
Operating result	1,876	+3.8%	1,947	-65.6%	670	+203.0%	2,030	+93.9%	3,938
Net interest	37		90		50		70		100
Other income	14		75		15		50		60
EBT	1,927	+9.7%	2,112	-65.2%	735	+192.5%	2,150	+90.6%	4,098
Taxes (excl. deferred taxes)	107		0		0		0		0
Consolidated earnings	1,820	+16.0%	2,112	-65.2%	735	+192.5%	2,150	+90.6%	4,098
Number of shares (fully diluted)	5,703		5,741		5,690		5,690		5,700
EPS	0.32	+15.6%	0.37	-64.9%	0.13	+192.5%	0.38	+90.2%	0.72

The capitalization of internal development projects initially boosts earnings, but will be amortized at an annual rate of 20%. This will cause costs in the future. The capitalization net of amortization will also reduce the cash flow.

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Revenue is assumed to be driven by online auctions, the gallery network and new products such as indices. These give artnet an outstanding strategic position.

According to our forecasts, the profit in 2007 will be achieved once more in 2009, but with revenue growth of 37%. Assuming the online auctions are successful to the degree we are predicting, artnet could generate much higher profits and distribute the greater part as dividends.

3. Valuation

Table 2

Calculation of enterprise value				
Discounted cash flow model in EUR thousand	2008	2009	2010	2011 ff.
Consolidated net income	735	2,150	4,098	4,098
Net Investment/working capital requirement	-700	-500	-200	
Free Cashflow (FCF)	35	1,650	3,898	4,098
Terminal value				61,997
Discount factor	1.020	1.103	1.192	1.192
Present values FCF	34	1,496	3,270	52,004
Total present values (fair value)	56,805			
Number of shares	5,690,000			
<b>Fair Value per share</b>	<b>9.98</b>			

Assumptions for calculation of enterprise value

Basic interest rate (current yield)	3,61%
Market risk premium	4,50%
Beta factor	1,00
CAPM interest rate	8,11%
Terminal value growth discount	1,50%

The DCF model was adjusted to take account of the lower current bond yield, the lower expected number of shares at the end of 2008 (including exercise of stock options) of 5.69 million, and the expected cash flows from the revised profit forecast. Due to the capitalization of development expenses, we have now included a line item "Net investments/working capital requirement", which will reduce the free cash flow. The valuation model with our assumptions indicates a current fair assessment of EUR 9.98 per share. The parameters of the sensitivity analysis were unchanged.

Table 3

artnet AG Sensitivity analysis DCF model			
in EUR per share	Beta		
	0.8	1.0	1.5
Growth discount			
1.0%	10.77	9.34	6.97
1.5%	11.64	9.98	7.32
2.0%	12.67	10.73	7.71

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**Main sources of information**

The main sources of information for the preparation of this analysis are publications in German and foreign media, such as information services, the business press, professional literature, published statistics, ratings agencies and publications by the analyzed companies/issuers.

**Analysis prepared by:**

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Layout: Michele Anne Zeh, CH-Windisch

**Investment recommendation**

Buy: We expect the price of these shares to increase by 15% or more in the coming 12 months  
Hold: We expect the price of these shares to fluctuate but only to change slightly in the coming 12 months  
Sell: We expect the price of these shares to fall by 15% or more in the coming 12 months  
N/A: We have not made a recommendation for these shares

**Overview of our analysis results for these shares in the past 12 months**

First analysis on February 25, 2008, Analysis Result: BUY EUR 11.25  
Follow-up study on May 26, 2008, Analysis Result: BUY EUR 12.50  
Follow-up study on August 28, 2008, Analysis Result: BUY EUR 12.00  
Follow-up study on November 14, 2008, Analysis Result: BUY EUR 9.50

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**Company: artnet AG**

**Numbers concerned: 3, 7**

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**Responsible supervisory authority**

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