IDEX Online Research: Potential Whitehall Buyers Say It's Nearly Worthless

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> FOR SALE: Jewelry chain, with 389 stores in great malls, good locations within the mall. Charming fixer-upper for someone with lots of time.

This is how a "For Sale" ad might read for Whitehall Jewellers. And, as anyone who buys real estate knows, "charming fixer-upper" is code for "needs major repairs," "it's a dump," or "might be easier to demolish than to rebuild." Unspoken, but clearly evident, in addition to "lots of time," the buyer should have "lots of money."

How Much Repair?

Two recent events illustrate just how distressed Whitehall is:

- **No income tax accrual** – As of the quarter ended October 2005, Whitehall is no longer accruing for income taxes. Companies stop accruing for taxes when it is unrealistic to believe that they will ever generate enough profits in the foreseeable future to pay taxes after allowing for deferred tax benefits (loss carryforwards). Whitehall has posted losses for every year since FYE 1/03.

- **$17 million offer for Whitehall** – Newcastle Partners has made an all-cash offer for Whitehall that values the company at just under $17 million. That's $17 million for all of its stores, its inventory, and the entire business. This token offer speaks volumes about the company's worth. Implicit in the deal, though, is that Newcastle will also need to raise, in our opinion, at least $100 million or more to keep the company afloat, in addition to existing capitalization.

What is Whitehall Worth?

Whitehall's balance sheet shows a net worth – owner's equity – of $24 million. That's calculated by subtracting liabilities from assets. Whitehall has roughly $250 million of assets (all relatively "hard" assets with no intangibles such as goodwill) and roughly $225 million of liabilities. When liabilities exceed assets, a company is technically bankrupt. Whitehall's debt ratio, according to our calculations, is over 85 percent, far above any other publicly held jeweler.

But a company is worth only what a buyer will pay. Because it is so debt-laden, so unprofitable, and so short of cash, would-be buyers are suggesting that it is nearly worthless – they won't even pay what the balance sheet says Whitehall is worth.

At its peak in 2000, Wall Street valued the company at $375 million; in 2002, it was still valued at $330 million by investors. At its lowest point in 2005, Wall Street valued Whitehall at only $11 million. Currently, Wall Street says Whitehall is worth only about $15 million. Thus, even Newcastle's current offer of $17 million represents a premium to Wall Street's valuation.
In short, Whitehall, with 389 stores generating just over $300 million in sales, with peak annual profits five years ago of just over $19 million, is nearly worthless, according to potential buyers and to Wall Street.

Proxy Fight Brewing
Despite it being a company that is apparently in dire straits, two suitors have publicly announced that they are willing to acquire Whitehall. Both offers reflect low valuations for a distressed situation, and they come with plenty of strings attached.

On the one hand, there is the Prentice Transaction, a deal to infuse secured capital into Whitehall via an $80 million of tiered financing. If this financing, which secures basically all of the company's assets, thus putting Prentice behind the banks but ahead of stockholders, is ultimately converted to common stock, Prentice partners would own 87 percent of Whitehall. The Prentice Transaction, supported by Whitehall management, includes capital from Prentice Capital Management and Holtzman Opportunity Fund. Holtzman Opportunity Fund is run by Seymour Holtzman, who ran a catalog showroom operation – Jewelcor – about 30 years ago. Prentice Capital recently acquired the Goody's Family Clothing chain and KB Toys.

On the other hand, there is the Newcastle offer, which Whitehall management has told shareholders to reject. Newcastle Partners announced a deal to buy Whitehall for $1.10 per share, later raised to $1.20 per share. This deal values Whitehall at roughly $17 million.

In fact, Whitehall is in the middle of a proxy fight – Prentice and Whitehall management versus Newcastle – just at the wrong time of year. There's never a good time for a proxy fight, but when you're trying to concentrate on the all-important holiday selling season, you can't be distracted by two suitors arguing over who is going to buy your company.

Worse yet, the proxy fight appears to be uneven, with Prentice and Whitehall on the losing end. Newcastle has contacted shareholders directly, soliciting shares for $1.20. On the other hand, based on SEC filings, Whitehall says it has called for a special shareholders' meeting on January 19, 2006. Shareholders are supposed to have 30 days notice for those meetings. Whitehall also filed documents indicating that management has sent a letter to shareholders advising them to reject Newcastle's offer. As of December 28, many shareholders have apparently received none of these communications from Whitehall. Clearly, Newcastle's proxy solicitors are doing their job while Whitehall's proxy solicitors have lapsed.

Testy Relationship Between Newcastle and Whitehall

While Newcastle principal Steven Pully was chairman of Whitehall's board for several months earlier this year, he tendered his resignation from the board on November 29, 2005, with a terse letter to Whitehall CEO Robert Baumgardner. This letter was obtained by IDEX Online Research, portions of which follow:

" . . . I can no longer remain a member of the Board of Directors of Whitehall Jewellers. I reach this conclusion based on several reasons, the overriding one of which is my belief that for reasons which I cannot understand, the Board does not seem to be acting in the best interest of Whitehall or its stockholders.

"Although previously not fully disclosed, Whitehall has been in financial difficulty since prior to my election to the Board on June 23, 2005."

"Unfortunately, my experiences on the Board over the past several months have caused me to strongly doubt the Board's interest in working constructively to best address Whitehall's serious problems. The Board's lack of effectiveness has contributed to a near complete devastation of shareholder value."

"Examples of the Board's actions include the following:

- **Improper formation and role of Special Committee.** On July 12, 2005, the Board discussed and formed a Special Committee at a time when I was not present and had no prior knowledge that the topic would be discussed. Although I had attended most of the Board meeting that day, at the relevant time I was instead meeting (with the approval of the Board) with a prospective Chief Executive Officer of the Company. I believe that this discussion and formation of the Special Committee at a time when I was not present was evidence of the Board's bad faith, just one week after I was elected Chairman of the Board. In forming the Special Committee, I believe that the Board gave undo [sic] authority to the Special Committee. Rather than just have the Special Committee determine the fairness of

any financing proposals, the Board effectively removed itself from directing the key questions of whether the Company needed to complete a financing and its structure, when it should be completed, what the size of the financing should be and with which party.

- **Unfair treatment of Newcastle**. During September 2005, Whitehall was actively searching for a financing partner. During this time Newcastle made several financing proposals to the Company. Newcastle was provided with little or no practical feedback from Whitehall and its representatives and given limited access to relevant parties, including Whitehall's trade creditors, despite Newcastle's repeated requests. Newcastle's goal was to facilitate the prompt completion of a transaction in the best interests of Whitehall. Obviously, the Board did not have the same goal in mind. Alternatively, during this time, Prentice made a series of written proposals which addressed concerns raised by the Board and the Special Committee and it appears was provided with greater access to relevant constituents. Newcastle was never given the same opportunity as Prentice to respond to Board concerns nor to top the Prentice offer accepted by the Board. While of course I agree that Newcastle should not have been given any advantages, Newcastle, the bidder who I believe was in the position to move the fastest, was practically excluded from the process, and if not excluded, definitely disadvantaged.

- **Superior Newcastle proposals have been ignored**. While we believe the Newcastle proposals in September were superior to the Prentice proposal ultimately accepted by the Board, Newcastle's October 26, 2005 offer to acquire all outstanding shares of Whitehall for $1.10 per share, representing a 37.5 percentage premium to the then current market price, was clearly superior. It is apparent to Newcastle, and based upon the market's response subsequent to our announcement, that the Newcastle proposal was a superior proposal. Whitehall's Board should have negotiated in good faith with Newcastle rather than hide behind an overly broad no-shop provision which was supposed to benefit stockholders. The obvious conclusion is that the Board is looking for reasons not to talk to Newcastle, rather than ways to get more money for Whitehall's stockholders.

- **Non-disclosure of material events in connection with Prentice offer.** I repeatedly questioned who was behind the Prentice offer. Representations were made to the Board that Prentice was providing all of the initial capital, and at no time was I informed Holtzman Opportunity Fund, L.P. would be a part of the financing. Given the change of control that was taking place and the role that the Holtzman Opportunity Fund,

L.P. aspires to play in managing Whitehall, one would question why Holtzman's identity was not previously disclosed.

- **Conflict by Special Committee Member**. The point in forming the Special Committee was to create a process that was fair to stockholders. This point was undermined by a conflict of interest of one committee member when the Chairman of the Special Committee, Daniel Levy, was discussed as an interim CEO candidate by Prentice before the Special Committee voted on the Prentice financing. The Board was made aware of this material conflict well after the fact and after there was an opportunity for the Board to correct this material error. Mr. Levy should have resigned immediately from the Special Committee following the suggestion that he be considered as interim CEO. Instead, Mr. Levy did not resign, but did accept the interim CEO title.

- **Board not engaging in proper corporate procedure.** I believe the Board minutes for meetings I have attended have consistently been inaccurate, and I have had to convey extensive comments to draft minutes provided. Further, the minutes from a significant number of the Board meetings held since early September have still not been circulated. The only plausible reason I can think of for this delay is that the Board wants to preserve the opportunity to, in a self-serving way, rewrite history without my input.

- **Removal as Chairman of the Board as an act of retaliation.** When the Board reviewed the proxy statement to be submitted to stockholders in connection with the Prentice financing, I made several comments, which after some reluctance were largely accepted. After the discussion on the proxy by the Board, the Board voted on it and I abstained because I voted against the Prentice transaction, among other reasons. Daniel Levy, in particular, was openly hostile at the board meeting about my vote, and immediately led the process to remove me as Chairman, stating that it was in retaliation for my abstention vote. Following my removal, Mr. Levy was elected as Chairman to replace me. Mr. Levy then made a motion to remove my comments from the proxy even though the proxy would have been misleading without my comments, although the Board disagreed and did not permit Mr. Levy to continue his crusade."

"At this point, with Newcastle Partners, L.P.'s announcement that it will be commencing a tender offer to acquire all outstanding shares of Whitehall for $1.20 per share, representing over a 50 percent premium over the share price prior to Newcastle's original $1.10 offer, I can no longer remain silent. This offer by Newcastle would treat all creditors of Whitehall substantially equivalent to their

treatment under the Prentice offer, and provides a significantly better return for Whitehall's stockholders. I can only hope that my resignation from the Board will motivate the Board to finally act in the best interest of Whitehall's stockholders and other constituents." /s/ Steven J. Pully.

Strategic Options for Whitehall: Run It or Liquidate It?

What would Newcastle do with Whitehall? In a letter to Newcastle, Whitehall chairman Dan Levy asked the potential investor to articulate its strategic plans for the company. The following, obtained by IDEX Online Research, is Newcastle's reply in a December 20, 2005 letter to Levy: ". . . with regard to Newcastle's strategic plans for the Company, we do not understand why it is relevant that the Board opine on our strategic plans regarding issues such as merchandising and inventory management that will pertain to the post-transaction period. Newcastle has offered (i) to acquire and intends to acquire, upon and subject to the satisfaction of the conditions in our offer and the back-end merger, all of the Company's outstanding capital stock, (ii) to replace in full or pay off the Prentice bridge facility, (iii) to replace the Company's senior credit and subordinate credit facility or obtain the consent of the senior lenders thereto and (iv) to honor the Company's agreements with the trade and its other contractual obligations. Therefore, we believe the topic of strategic plans is yet another attempt by the Board to confuse the real issue, whether this transaction is in the best interests of the Company's stockholders and any other constituents to whom the Board owes a fiduciary duty. Given the capitalization proposed by both Prentice and Newcastle, that duty, as you are aware, should be primarily to the Company's stockholders."

What does this mean? Clearly, Newcastle suggests that Whitehall is worth very little as a going concern, based on its offer which values the equity of the company at only $17 million. Therefore, it is possible that Newcastle may break up Whitehall and sell pieces of it to others. Further, it is possible that Newcastle may liquidate the company and attempt to auction the real estate leases – most of which are for good locations in better malls. By rebuffing the board's question about "strategic plans," we believe that Newcastle may not want to expose its ultimate plans for the company.

Whitehall Acknowledges Its Problems

How bad are the problems at Whitehall? Here's an abbreviated list of risks which Whitehall enumerates in its recent SEC filings:

- **If we fail to consummate the Prentice transaction, we may be unable to continue as a going concern.** *Management's comment:* "We believe that the financing provided by the Prentice Transaction will provide sufficient funding for the next few months. If, for any reason, the Prentice

Transaction is not consummated . . . [it] may force the Company to consider the sale of assets or . . . a reorganization under Chapter 11 of the U.S. bankruptcy code."

- **Our current levels of debt could impact our operations in the future.** *Management's comment:* "As of October 31, 2005, we had approximately $144.1 million of outstanding debt, constituting approximately 76.5 percent of our total debt and stockholders' equity.* We are more highly leveraged than many of our competitors which may place us at a competitive disadvantage . . . and make us more vulnerable to changes in economic conditions. Our borrowing costs are higher than many of our competitors." In addition, a substantial portion of Whitehall's debt is floating rate. As interest rates continue to rise, Whitehall will be adversely affected. *(*IDEX Online Research calculates this measure at 85 percent using more conservative accounting methods.)*
- **If we lose key personnel or are unable to attract additional qualified personnel, our business could be adversely affected.** *Management's comment:* "It is likely that there will be changes to our management team and other personnel as we focus on improving execution and reducing costs. We have experienced high turnover among our marketing and field personnel, especially store managers, and other personnel in recent periods, which has had an adverse impact on our results."
- **We face competition.** *Management's comment:* "A number of our competitors are substantially larger and have greater financial resources. We also face significant new competition from internet jewelry retailers. We do not transact internet sales of jewelry."
- **We depend on our major suppliers . . . and we will need their support to maintain our liquidity.** *Management's comment:* "Our largest five suppliers accounted for approximately 38 percent of purchases. In recent periods, we have requested temporary extensions of payment terms . . . and have slowed our accounts payable schedules. Our liquidity depends on our vendor support. A substantial portion of the merchandise we sell is carried on a consignment basis." For the fist six months of 2005, more than 28 percent of the company's total inventory consisted of memo goods.
- **We face securities litigation, shareholder derivative litigation, and other proceedings which could be material.** *Management's comment:* "We are defendants in securities litigation, shareholder derivative litigation and other proceedings. [These are summarized in detail in the company's financial statements.] In connection with the Capital Factors litigation, we entered into a non-prosecution agreement with the U.S. Attorney's Office. The non-prosecution agreement contains certain conditions. If we fail to meet the conditions . . . we could face criminal prosecution."

- **We may take additional accounting charges on our financial statements.** *Management's comment:* "For the nine months ended October 31, 2005, we recorded a non-cash impairment charge of $9.0 million relating to long-lived assets . . . at 31 retail stores. There can be no assurance that we will not take additional impairment charges."
- **The costs associated with our store closing program may be material.** *Management's comment:* "During the third quarter . . . the company recorded . . . an impairment charge of $5,033,000. The impairment charge [is related to the closing of] 77 of the company's retail stores and for the reduction in carrying value of two additional stores which will continue to remain open. The company expects to close the 77 stores by February 2006. To assist with the closing of these stores, the company entered into an agreement . . . with a third party. The company will receive cash proceeds from the liquidating stores of not less than 55 percent of the cost of the merchandise inventory plus certain expenses. The company recorded an inventory valuation allowance of $17.9 million [in the October quarter]. Additional inventory valuation allowances may be required. In addition, the company also entered into an agreement with another third party for the purpose of selling, terminating, or otherwise mitigating lease obligations related to the store closings."
- **We need to alter the composition of our inventory to successfully execute our business strategy.** *Management's comment:* "A substantial portion of our inventory consists of items we do not plan to incorporate into our merchandising strategies on a long-term basis. The success of our business strategy will depend . . . on our ability to sell such merchandise that would no longer be a part of the company's future merchandise presentation effectively as well as to sell a substantial amount of other inventory that has been slow-moving historically."
- **We may incur costs and disruptions in connection with moving to a new facility.** *Management's comment:* "The lease at the . . . corporate headquarters, distribution functions, and quality assurance operations expires on December 31, 2005. We are currently negotiating a lease extension; however, the landlord has indicated that it ultimately intends to replace the building. If this occurs, we will need to find a new location for these operations which may be at a higher lease rate than the rent we pay currently. In addition, moving these functions to a new location may result in substantial disruptions to our operations."
- **The issuance of common stock underlying the notes and the warrants as contemplated by the Prentice Transaction will have a severe dilutive effect on the interests of our existing stockholders and option holders.** *Management's comment:* "The shares of the common stock issuable [under the Prentice Transaction] will represent 87 percent of the issued and outstanding shares of our common stock. If the

notes are converted into shares of common stock, Prentice will be able to control the vote on almost all matters submitted to our stockholders. [Prentice] may have interests that are different from, or in addition to, its interest as a stockholder."

- There are other risks – perhaps less onerous – which are too numerous to list.

Last year, Whitehall received an unqualified opinion from its external auditors. Based on the risks listed above as well as continued losses, it is likely, in our opinion, that Whitehall will receive a qualified opinion this year. Further, we believe it will be qualified with a "going concern" clause stating that there is reasonable doubt about the company's ability to sustain its operations longer term.

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IDEX Online Research is headed by leading industry analyst Ken Gassman. For over 20 years, Ken has been a leading retail and consumer analyst on Wall Street, covering the global diamond and jewelry trade, working with major national U.S. retailers including Wal-Mart and Home Depot as well as jewelers such as Zale Corporation, Signet Group, Movado, and others.