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IDEX Online Research

Whitehall: Under Siege

By Ken Gassman

Whitehall Jewellers continues to remain in the news . . . mostly for the wrong reasons. It is bad enough that its financial results are disappointing; sales have been trending down for the past five years and losses are mounting. In addition, the company has been challenged by a number of other factors – many beyond its control – that have diverted management's time, energy, and focus from its core jewelry business.

The bottom line question is this: Will Whitehall survive long term?

IDEX Online Research examines the challenges which have interfered with Whitehall's day-to-day business of selling jewelry. While we are unwilling to sound the death knoll for Whitehall, we can say this: it will take longer and cost more to bail Whitehall out of this life-or-death situation than anyone can imagine. Thus, the question about Whitehall's long term prospects can only be answered by its new owners – whomever they end up being. Will these new owners have sufficient money and patience to nurse this sick company back to health?

Here is the legacy of challenges that Whitehall and its potential new owners will face, as they attempt to dig the company out of its current quagmire:

- Whitehall's sales productivity is sub-par by almost every benchmark used to measure retailers' financials.
- Whitehall's profitability has evaporated; the company has been unprofitable for the past three years.
- Whitehall stopped accruing for income taxes in the third quarter of 2005, saying that it was unsure if it would ever generate enough profits to offset the accrued tax-loss carry forwards. This could lead to a "going concern" opinion by its accountants; this means that that the auditors will question whether the company has long term sustainability.
- Whitehall has a capital crisis. Last fall, the company said it was seeking an infusion of capital to keep it afloat.

- Management has mentioned bankruptcy as an alternative to give the company time to reorganize.
- Turmoil among the board and top management has taken its toll, especially in 2005.
- Legal investigations by the SEC, the New York Attorney General's office, and Capital Factors diverted management's time and energy from day-to-day operations. In addition, the company spent millions defending itself, only to end up paying a hefty fine to stop the investigations.
- Amidst all of these challenges, the company has attempted to reposition itself as a more upscale jeweler. The only problem is that someone forgot to tell its store employees.
- Whitehall has announced plans to close roughly 20 percent of its store base. It will be difficult for management to scale back its support infrastructure enough to generated needed efficiencies to support a smaller store base, in our opinion.
- Finally, who will end up owning the company? Whitehall has two suitors; the board has vacillated between choosing one over the other. The decision should be based on more factors than simply who is offering the most money; unfortunately, the board does not seem to be evaluating those other factors.

IDEX Online Research notes that even if Whitehall is able to survive all of this turmoil, there is a bigger question: does the consumer market really need Whitehall? Based on the level of consolidation in other retail and consumer sectors – notably consumer electronics, home centers, office supplies, pet supplies, department stores, discounters, even the airline industry – it is difficult to make a case for Whitehall's long term survival.

Our analysis follows:

Whitehall Jewellers: Will It Survive Long Term?

Like a confused bride hotly pursued by two suitors, Whitehall Jewellers can't seem to make up its mind who it will marry: Newcastle Partners or Prentice / Holtzman. Both have offered to buy Whitehall, each trying to outbid the other. Whitehall's board continues to flip-flop as it tries to decide.

Historically, the bride provides the wedding dowry. But this is the 21st century; women want to know that their potential mate has enough money to support their expected standard of living. In the case of Whitehall, that's a serious question, because we believe that it will take longer and cost more than anyone can imagine to dig the company out of its current financial quagmire. The real question is this: will Whitehall's new owner – whoever it may be – have the

financial strength and patience to nurse Whitehall – a very sick company – back to health?

Whitehall's Decision: Not an Easy One

It is never easy to decide between multiple suitors. On one hand, there is the easily quantifiable information: who brings the most capital, goods, and other trappings of wealth to the marriage. On the other hand, brides must also listen to their hearts. Unfortunately, Whitehall can't do so because its owners – shareholders – typically vote based on the size of the suitor's bank account. He who brings the most money to the party wins. Period.

In Whitehall's case, its quest for capital turned into a bidding war between two investors: Newcastle and Prentice / Holtzman. Prentice / Holtzman initially planned to provide capital in a complex deal that would have made them controlling shareholders and given them roughly 90 percent of the voting power. While existing shareholders were asked to vote on the deal, it was viewed by some as a give-away of the company. Newcastle principals, one of whom had previously sat on Whitehall's board, countered with a bid of $1.10 per share last fall, saying that their deal for more fair for shareholders. Since then, each side has sweetened the deal. And with each sweetener, Whitehall's board has switched its support to the party bringing the most money.

As the bidding has escalated, terse missives have been hurled among the parties. While the battle has not degenerated into a typical political mudslinging contest, much sarcasm has been thrown around.

As it stands currently, the Prentice / Holtzman partnership has the high bid of $1.60 per share for the company, but Newcastle says it is still in the bidding.

We don't know who is going to win, but here's our analysis of how possible outcomes might affect Whitehall's stakeholders:

- **Whitehall's current suppliers** – You should want Prentice / Holtzman to win. They have a history in the industry, and they are likely to make the fewest changes at Whitehall. Most of the current management staff will likely stay in place. Conversely, as a supplier, you better hope that Newcastle does not become Whitehall's new owner. Newcastle is likely to replace most of the company's current top management (this is solely our opinion). We sense that Newcastle has the attitude that Whitehall got into its current financial distress with existing management, existing employees, and existing suppliers. In our opinion, Newcastle's attitude is likely to be "out with the old, in with the new." Existing suppliers, even if they are doing a good job, will be re-evaluated and could be replaced.

- **Whitehall's current shareholders** – At this point, you've probably already lost most of your original investment. On one hand, you can argue that you'd like to get something – even if it is just a few pennies – and move on. On the other hand, you can argue that since you've lost most of your money, you really don't care about the remaining few pennies you still have invested. Based on the original offers, the Newcastle deal would have put a few pennies in your pocket and eliminated one more losing stock from your portfolio. However, the current Prentice / Holtzman offer trumps anything Newcastle has bid so far.

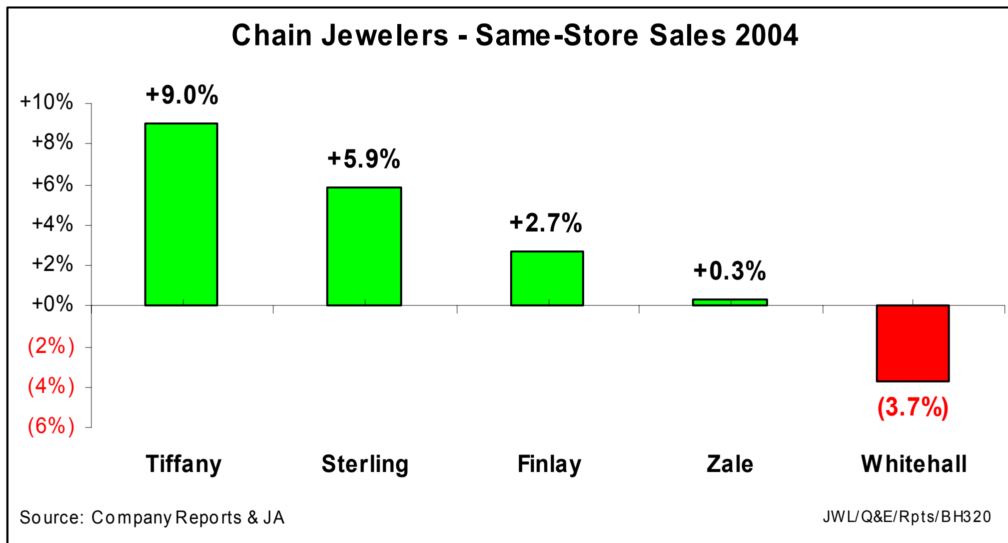
Whitehall Needs to Go Private
As a vendor or a shareholder, what you don't want right now is an ownership position in Whitehall Jewellers. Here's why:

- Whitehall needs to go private so it can make tough, unpopular decisions out of the prying eyes of public shareholders and the SEC. Many stores need to be closed (more than the company has already announced). Personnel need to be cut. This is a life-or-death situation, and management can't have any second-guessing by disgruntled shareholders or attorney general's offices. Management will likely use Chapter 11 bankruptcy to get out of unfavorable leases. In Chapter 11 bankruptcies, existing shareholders virtually always lose all of their money.

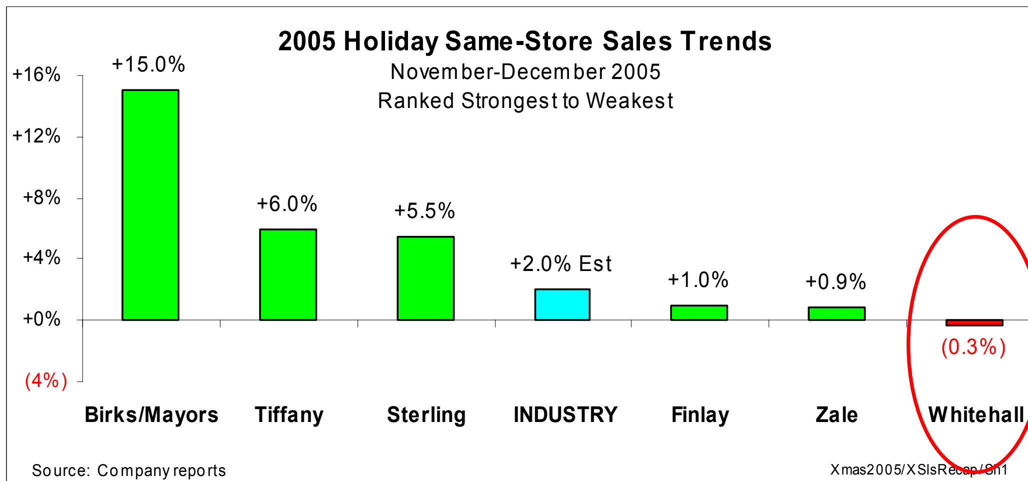
However, the odds of a long term future for Whitehall are slim. We reiterate: it will take longer and cost more to get Whitehall back on track than anyone can imagine.

Here are some issues that Whitehall will need to face in its uphill battle for survival:

- **Whitehall's sales productivity is below average by just about every measure** – As a result of weak sales productivity (see graph below), Whitehall's ability to generate a profit are under much more pressure than its key mass market competition. The problem is simple: fixed expenses are too high for its current sales level. But because Whitehall's infrastructure is designed for a store base approaching 400 units, it can't easily remove many of those relatively fixed costs.



Recent sales trends for Whitehall remain unchanged. For the 2005 holiday selling season, it posted the weakest sales of any jewelers in its peer group, as the graph below illustrates.



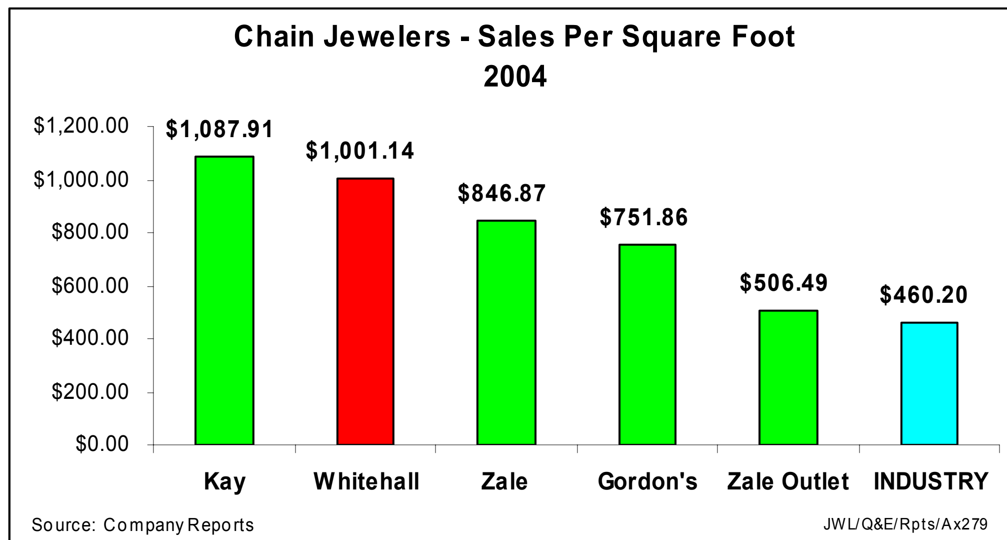
We note, however, that the company entered into the all-important holiday selling season with lower levels of inventory, both owned and memo. Inventory levels shown on the balance sheet as of October 2005, when inventories should be near their annual peak, were about $185.7 million, down 8 percent from the prior year. This reduction was principally related to revaluation of merchandise slated for liquidation, but the point remains: the value of its merchandise available for sale was down year-to-year. In addition, Whitehall's consignment inventory levels at the end of the October 2005 quarter were $65.2 million, down 20 percent from the prior

year. In short, Whitehall's weak holiday sales were a self-fulfilling prophecy due to a lack of goods to sell.

Strong sales productivity can cover many operating sins; unfortunately, Whitehall's poor sales have spotlighted its weaknesses. Its sales productivity is low due to the following factors:

- **Smaller stores hurt sales productivity** – The typical Whitehall Jewellers store is 874 square feet, or roughly half the size of a typical mass market chain jewelry store. Whitehall management touts its smaller stores as a competitive advantage. Management claims that sales per square foot are higher than the average mass market store, rents are lower, and they are more flexible. Here's what our analysis shows:

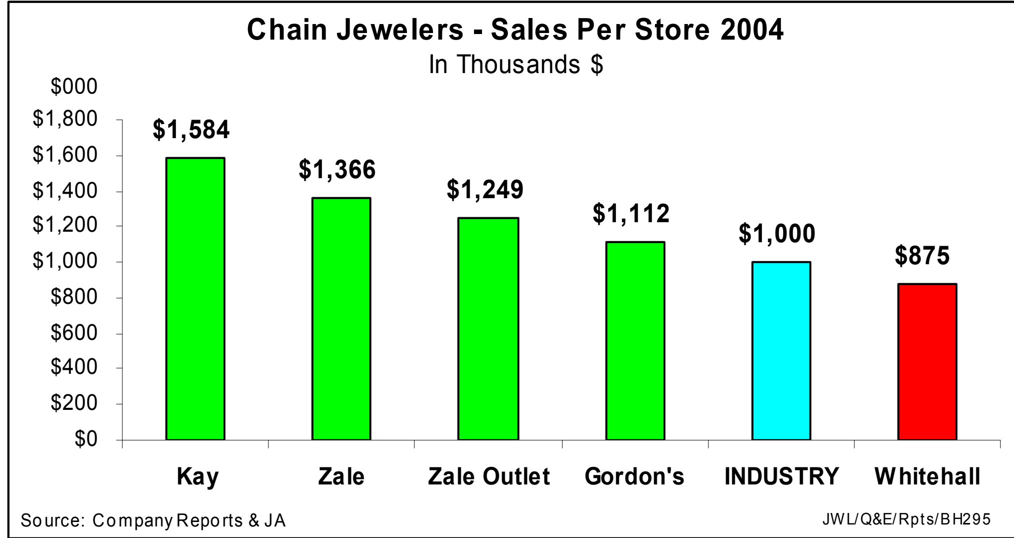
  - **Whitehall's sales per square foot are at the high end of its peer group** – As the following graph illustrates, Whitehall's sales per square foot are above Zale's, but below Sterling's (Kay & regional brands, not including Jared). Further, Whitehall's sales per square foot are more than double the industry average, though this average is heavily weighted with independents doing far too little business in oversized stores.



Most jewelers measure their productivity based on linear running feet of display; public jewelers do not reveal enough information for us to calculate this measure. However, recently Whitehall added national branded watches to its mix, and management lamented that it needed to eliminate

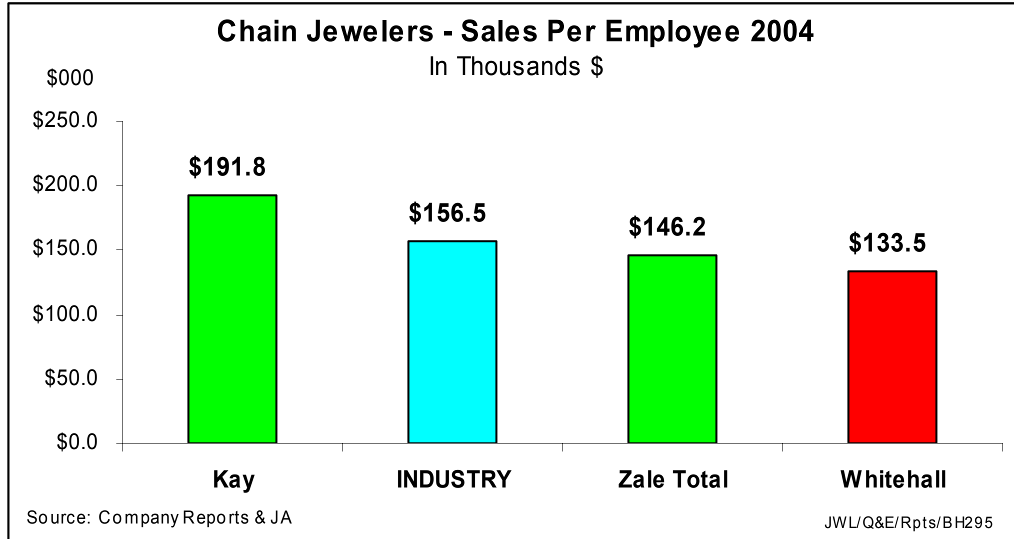
some existing jewelry lines to make space for these watches. Watches typically sell for a below-average gross margin, but they can help build customer traffic.

- **Sales per store well below average** – As expected, Whitehall's sales per store are well below the average sales per store for all of its mass market competition, as the graph below illustrates.



Sales per employee below average – Whitehall's sales per employee are the lowest of any of the mass market jewelers, as the graph below illustrates.

- **Rent information is not available, but efficiencies are**

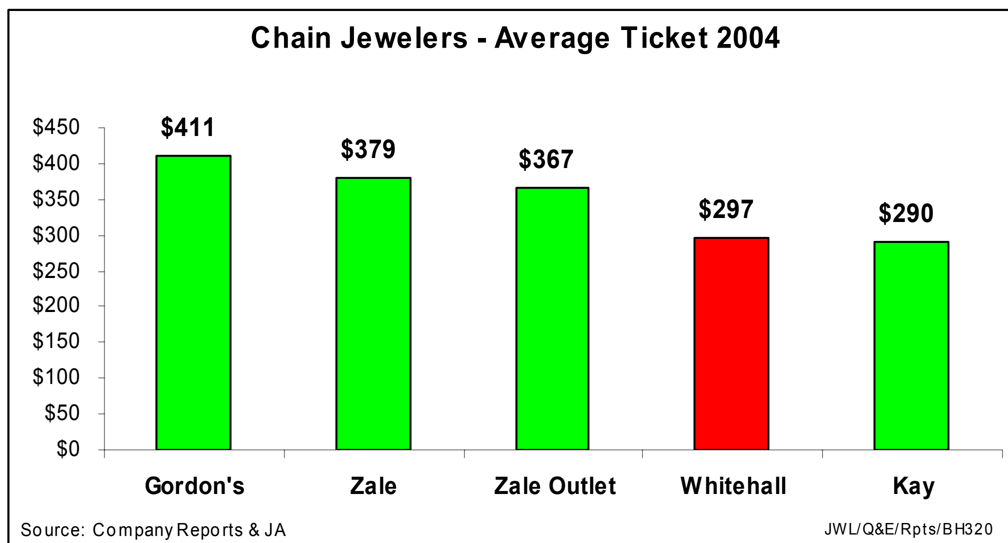


unlikely here – The public companies do not provide

enough information to calculate rent comparisons with any degree of accuracy. However, there are two generalities we can conclude: 1) mall landlords are not giving Whitehall any concessions on rent expense; if anything, Whitehall's rent may be slightly higher due to its smaller footprint. And 2) because of Whitehall's high traffic, high visibility, choice locations in malls, its rent expense is probably among the highest of any mall tenant.

- **Stores are not flexible** – With smaller stores, there is little opportunity for Whitehall to leverage sales and profits by adding merchandise or re-arranging its display space. The company is locked into small, generally corner locations with minimal flexibility.

- **Average ticket is below most of its competition** – Whitehall's average ticket is below the average ticket of Zale's three major mass market brands. Interestingly, however, it is slightly above Sterling's average ticket. IDEX Research calculates that it costs a typical jeweler about $78 in sales and marketing expense to generate a sale, regardless of the size of the ticket. Thus, bigger tickets can help absorb relatively fixed costs more efficiently. In short, a higher ticket can provide dramatic profit leverage. The



graph below summarizes the average ticket for mass market jewelers.

- **Key financial benchmarks are below average** – Whitehall does not measure up to its publicly held competition based on typical financial benchmarks. For example, its gross margin is the lowest of its peer group.

While its operating expense is low, as a percentage of sales, this provides no profit leverage. In fact, Whitehall has been unprofitable for the past two years (FYE January 2004 and January 2005), and it is expected to be unprofitable for the fiscal year just ended (FYE January 2006). The following table summarizes key financial productivity measures for Whitehall versus its peer group.

Key Financial Benchmarks

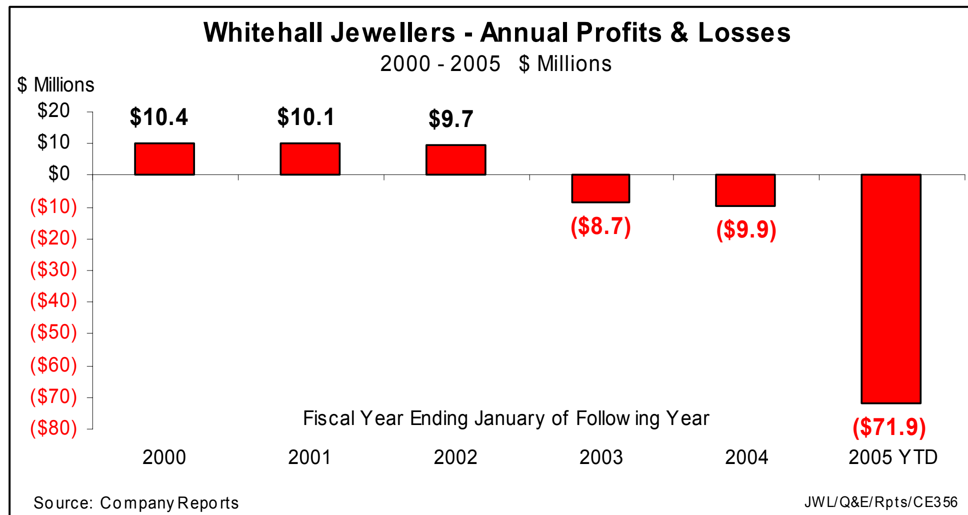
Chain Jewelers - 2004

	Gross Margin	Operating Costs %	Pretax Margin
Whitehall	33.8%	36.7%	(4.2%)
Sterling	n/a	n/a	12.6%
Tiffany	56.0%	42.6%	12.6%
Zale	51.4%	41.2%	7.1%
INDUSTRY	49.2%	44.9%	3.9%
Finlay	50.8%	42.9%	2.6%

Source: Company reports & JA JWL/Q&E/Rpt/BX330

- **Due to heavy losses, the company has stopped accruing for income taxes** – This is a significant accounting milestone that is easily overlooked, unless you spend much time analyzing Whitehall's income statement and reading its financial filings. Beginning with the quarter ended October 2005 (late last year), the company ceased accruing for income taxes because it is unclear if Whitehall will ever generated sufficient profits to offset its accumulated tax loss carryforwards (accrued taxes).

  Based on this as well as other financial deterioration, we believe that Whitehall's accountants will likely issue a "going concern" opinion for its fiscal year ended last month (January 2006). A "going concern" opinion expresses some doubt about the long term viability and sustainability of the organization which is being audited.



- **Troubles rooted in the past** – Whitehall's troubles began in earnest in 2003 when it was hit with three punches in rapid succession. These punches diverted management from the day-to-day operations of the company.
    - Capital Factors alleged that Whitehall committed fraudulent acts in its relationship with bankrupt Cosmopolitan Gem, one of Whitehall's major suppliers.
    - The New York Attorney General's office announced an investigation of Whitehall.
    - The Securities & Exchange Commission (SEC) began a formal investigation of Whitehall.

  In the end, after spending millions for lawyers, accountants, and other professionals, Whitehall paid nearly $13 million in settlement costs in late 2004 to avoid further litigation.

- **Management turmoil continues** – Personnel turnover, especially at the top, has been higher than average. In early 2005, Hugh Patinkin, chairman and CEO passed away unexpectedly. Further, as on-going investigations by both the New York attorney general and the SEC unfolded, personnel at Whitehall exited. In addition, the company's president, Lucinda Baer, resigned in the fall after it became apparent that she was going to be replaced.

  Whitehall experienced monumental embarrassment in the Fall of 2005 when it announced that it had hired industry veteran Beryl Raff to become CEO, only to have Raff resign from the position before she showed up for work. Litigation related to this issue has diverted management time, energy, and money. No public statement has ever been issued by either party about the reasons for this annulment.

Finally, just prior to the all-important holiday selling season, the company hired Robert Baumgardner from Little Switzerland to run the company. Because the company had been adrift without a leader from early 2005 until very late in the year, it was unprepared for the 2005 holiday selling season, despite the best efforts of Baumgardner.

Turmoil among the board of directors – In the spring of 2005, Newcastle Partners announced that it owned just over 14 percent of Whitehall's common shares. Newcastle, an investment firm that invests in under-performing companies and then tries to turn them around, obtained a seat on Whitehall's board. Subsequently, the Newcastle board member is named Whitehall's board chairman, but later resigned the chairmanship, and eventually gave up his board seat in November 2005. As the board chairmanship moved from person to person, Dan Levy, an industry veteran who presided over the demise of Best Products and has helped other troubled companies, emerged at the leader of the board. The problem, though, is that Levy really would like to retire, in our opinion. Our sense is that he is a reluctant chairman. What Whitehall needs right now is a strong leader. Levy has all of the qualifications, but we are not sure that he wants the job.

- **Repositioning under way** – In late 2004, Whitehall began to try to reposition the company as a higher-end jeweler, away from the mass market. The company's 2004 holiday catalog was a dramatic change from prior years, and differentiated the company from other mass-market jewelers. Subsequent advertising – even as recently as the 2006 Valentine's flyer – has continued to position the company as an upscale jeweler. Unfortunately, the repositioning has apparently confused consumers, and the company has reported a string of same-store sales declines. Further, as part of the move to reposition the company, management began a program to sell up to $70 million worth of inventory – roughly 1/3 of its total merchandise – at distress prices, so cash could be generated to purchase new goods. Our mystery shopping visits reveal that Whitehall's employees do not know that the company is trying to move upscale.

- **Stores in poor locations for a successful repositioning** – Whitehall management has long sought highly visible, high traffic mall locations, often near the food court. This was a way to attract younger consumers as well as maintain high visibility for its mass market jewelry line. Unfortunately, these locations may not the best spots for upscale luxury jewelers. The hubbub of mall rats in the midst of a food fight is not conducive to making big ticket jewelry sales. Whitehall will need to seek different store locations in malls, if it plans to project the image of an upscale jeweler.

In its SEC filings, Whitehall says its stores – especially its new stores – are in "better" malls around the country. We are unsure what "better" means, but we can say this: Kay, Zale, Helzberg, and others are also in those same malls. In short, Whitehall does not have a competitive advantage based on the location of its stores. In fact, we argue that its current store locations are a competitive disadvantage for a jeweler trying to project an upscale image.

- **Whitehall is short of capital** – Without capital, a company cannot pay its bills. In the fall of 2005, Whitehall disclosed it was running short of cash, and its banks sent a default letter. Whitehall's shares plummeted in price from around $9-10 per share to around $1; this caused them to be kicked off the New York Stock Exchange.

  In its quest for capital, Whitehall stirred up a hornet's nest. This also diverted management time, energy, and capital, because it has been a fight between two parties, with Whitehall vacillating over picking a favorite.

  - **Prentice Deal** – Initially, in the fall of 2005, a deal was announced to sell the equivalent of up to 87 percent of the company in exchange for $80 million of tiered financing 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. Most recently, the Prentice / Holtzman partnership has agreed to bid $1.60 per share for all of Whitehall's stock. The board has accepted this bid.

  - **Newcastle Offer** – Subsequent to the Prentice deal, Newcastle Partners announced a deal to buy Whitehall for $1.10 per share, later raised to $1.20 per share. After much sparring over details and an apparent lack of disclosure, Newcastle offered $1.50 per share, which the board finally accepted. However, with the latest Prentice / Holtzman deal, Whitehall's board has withdrawn its support of the Newcastle deal, and it now says that the Prentice / Holtzman deal is best for the company and stakeholders.

- **Whitehall is likely to file for bankruptcy** – Despite the prospects that the company will obtain a capital infusion, it will be much easier to "fix" Whitehall by declaring bankruptcy. This could allow the company to walk away from store leases without any liability and put vendors' payables on indefinite hold. In addition to the store closings already announced – 77 units – we would expect additional stores to be closed, if the company elects to file Chapter 11 bankruptcy.

How badly would vendors be hurt by a bankruptcy filing? Whitehall's latest financial filings indicate that it ended the October 2005 quarter with roughly $46.2 million of vendor payables, down about 20 percent from the prior year's $57.3 million. Aside from some valuation issues related to liquidation merchandise, we believe that vendors have Whitehall on a tight leash. This reduced level of payables also meant that Whitehall was entering the all-important holiday selling season with about 8 percent less merchandise than the prior year, based on year-to-year inventory levels. Further, vendors cut back on memo goods by 20 percent going into the holiday selling season. There could be many reasons for the reduction of memo – consignment – inventories, but we believe they are ultimately related to Whitehall's current financial weaknesses.

- **Whitehall's shrunken store base will add to inefficiencies** – With fewer stores, the company will need to shrink its infrastructure. History has proven that this is very difficult for most companies. Further, with fewer stores, it will lose advertising efficiencies. For example, Kay and Zale utilize national television; Whitehall will not have the ability to use this highly efficient medium because it will have 300 or fewer stores in a reduced number of markets.

- **The pending corporate headquarters dislocation is a drag** – Whitehall's lease on its corporate headquarters ended last year; it is currently renting its offices on a month-to-month basis. Its landlord wants the space back immediately. Assuming Whitehall moves its corporate offices, it will add significantly to the current turmoil.

- **Whitehall is very open about potential risks –** In its most recent annual filing with the SEC, Whitehall lists 19 risks that face the company. By contrast, Signet Group lists 16 risks that it faces, and Zale lists 10 risks that it faces.

The Critical Question: Does the Market Need Whitehall?
In most retail and consumer sectors, there are now only two or three major competitors. This is a dramatic change from years ago when there were many different retailers competing in a category. For example, today there are two dominant home center chains, Lowe's and Home Depot. Formerly, there were a dozen major chains such as Hechinger, Payless Cashways, Home Quarters, Grossman's, Pay 'N Pak, and others. In the consumer electronics industry, Circuit City and Best Buy dominate; formerly, there were chains such as Crazy Eddie, Newmark & Lewis, Highland Appliances, Federated Group, Audio Video, and others. Other sectors with obvious consolidation include discounters (Wal-Mart, Target, Kmart), office supplies (OfficeMax, Office Depot, Staples), pet supplies, sporting goods, and others. For all practical purposes, there are no

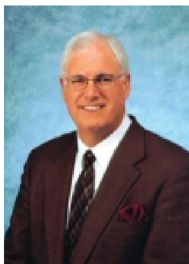
independents competing is these markets, except in fringe areas such as luxury goods.

The jewelry industry is undergoing rapid consolidation. Many in the industry are questioning whether the jewelry industry will eventually consolidate to a duopoly (two major competitors) or a triopoly (three major competitors). While we are not in a position to say who might emerge in this game of musical chairs, it would appear that Whitehall may have less of a chance of survival when the music stops.

The only good news to come out of this situation is that retailers typically die very slowly. Retailing is not a capital intensive business. Thus, by shrinking its store base by about 10 percent per year, a retailer can generate enough cash flow to maintain operations, even if loses are mounting. With Whitehall planning to close 20 percent of its stores momentarily, and the potential for more store closings, it will likely continue to operate for the foreseeable future.

About IDEX Online Research

IDEX Online Research is a division of IDEX Online (www.idexonline.com) which produces real-time transparent, unbiased pricing information for the global diamond and jewelry industry. IDEX Online Research provides exclusive, in-depth analysis of the global diamond and jewelry trade, industry research, retail and consumer analysis, as well as trend forecasts and financial breakdowns.



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.