

PARTY CITY CORP
Form 10-Q
May 17, 2004

Table of Contents

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended **Commission file number**
March 27, 2004 **0-27826**

Party City Corporation
(Exact name of registrant as specified in its charter)

Delaware **22-3033692**
(State or other jurisdiction of incorporation or organization) *(I.R.S. Employer Identification No.)*

400 Commons Way **07866**
Rockaway, New Jersey *(Zip Code)*
(Address of Principal Executive Offices)

973-983-0888
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No:

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No:

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

As of May 3, 2004, there were 17,046,757 shares of Common Stock, \$0.01 par value, outstanding.

TABLE OF CONTENTS
PARTY CITY CORPORATION AND SUBSIDIARY

| | <u>Page No.</u> |
|--|-----------------|
| <u>Part I Financial Information</u> | |
| <u>Item 1. Financial Statements</u> | |
| <u>Condensed Consolidated Balance Sheets (Unaudited) March 27, 2004, March 29, 2003 and June 28, 2003</u> | 3 |
| <u>Condensed Consolidated Statements of Operations (Unaudited) for the quarters and nine months ended March 27, 2004 and March 29, 2003</u> | 4 |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the nine months ended March 27, 2004 and March 29, 2003 (as Restated - See Note 12)</u> | 5 |
| <u>Notes to Condensed Consolidated (Unaudited) Financial Statements</u> | 6 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 13 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 25 |
| <u>Item 4. Controls and Procedures</u> | 26 |
| <u>Part II Other Information</u> | |
| <u>Item 1. Legal Proceedings</u> | 27 |
| <u>Item 2. Changes in Securities, Use of Proceeds, and Issuer Purchases of Equity Securities</u> | 27 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 27 |
| <u>Item 4. Submission of Matters to a Vote of Security Holders</u> | 27 |
| <u>Item 5. Other Information</u> | 27 |
| <u>Item 6. Exhibits and Reports on Form 8-K</u> | 27 |
| <u>Exhibit Index</u> | 27 |
| <u>Signatures</u> | 27 |
| <u>AMENDED & RESTATED CERTIFICATE OF INCORPORATION</u> | |
| <u>CERTIFICATION</u> | |
| <u>CERTIFICATION</u> | |
| <u>CERTIFICATION</u> | |
| <u>CERTIFICATION</u> | |

References throughout this document to the Company include Party City Corporation and its wholly-owned subsidiary. In accordance with the Securities and Exchange Commission's Plain English guidelines, this Quarterly Report on Form 10-Q has been written in the first person. In this document the words we, our, ours and us refer only to Party City Corporation and its wholly-owned subsidiary and not to any other person.

The Company's website www.partycity.com provides access, free of charge, to the Company's SEC reports, including Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to these reports.

You may also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. You may obtain information on the operations of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains a website that contains reports, proxy and information statements and other information regarding issuers that file electronically with the SEC, including us, at <http://www.sec.gov>.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****PARTY CITY CORPORATION AND SUBSIDIARY****CONDENSED CONSOLIDATED BALANCE SHEETS**(in thousands, except share information)
(unaudited)

| | March 27, 2004 | March 29, 2003 | June 28, 2003(1) |
|---|---------------------------|---------------------------|-----------------------------|
| | <hr/> | <hr/> | <hr/> |
| ASSETS | | | |
| Current assets: | | | |
| Cash and cash equivalents | \$ 15,773 | \$ 3,036 | \$ 3,372 |
| Merchandise inventory | 61,104 | 76,156 | 65,908 |
| Other current assets, net | 19,570 | 20,819 | 21,900 |
| | <hr/> | <hr/> | <hr/> |
| Total current assets | 96,447 | 100,011 | 91,180 |
| Property and equipment, net | 49,242 | 53,432 | 52,819 |
| Goodwill | 18,614 | 19,172 | 18,614 |
| Other assets | 5,117 | 4,152 | 5,386 |
| | <hr/> | <hr/> | <hr/> |
| Total assets | \$169,420 | \$176,767 | \$167,999 |
| | <hr/> | <hr/> | <hr/> |
| LIABILITIES AND STOCKHOLDERS EQUITY | | | |
| Current liabilities: | | | |
| Accounts payable | \$ 35,796 | \$ 46,272 | \$ 37,960 |
| Accrued expenses and other current liabilities | 30,599 | 21,139 | 24,998 |
| Cash overdraft | 106 | 2,641 | 4,126 |
| Advances under Loan Agreement | | 18,637 | 11,229 |
| | <hr/> | <hr/> | <hr/> |
| Total current liabilities | 66,501 | 88,689 | 78,313 |
| Long-term liabilities: | | | |
| Deferred rent and other long-term liabilities | 9,818 | 10,759 | 10,264 |
| Commitments and contingencies | | | |
| Stockholders equity: | | | |
| Common stock, \$0.01 par value, 40,000,000 shares authorized; 17,760,444 shares issued and 17,013,432 shares outstanding at March 27, 2004; 17,177,151 shares issued and 16,430,139 shares outstanding at March 29, 2003; and 17,296,807 shares issued and | 178 | 172 | 173 |

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| | | | |
|--|-------------------|-------------------|-------------------|
| 16,549,795 shares outstanding at June 28, 2003 | | | |
| Additional paid-in capital | 45,073 | 41,662 | 43,178 |
| Retained earnings | 53,790 | 41,425 | 42,011 |
| Treasury stock, at cost (747,012 shares for all periods presented) | (5,940) | (5,940) | (5,940) |
| | <u> </u> | <u> </u> | <u> </u> |
| Total stockholders' equity | 93,101 | 77,319 | 79,422 |
| | <u> </u> | <u> </u> | <u> </u> |
| Total liabilities and stockholders' equity | \$169,420 | \$176,767 | \$167,999 |
| | <u> </u> | <u> </u> | <u> </u> |

(1) The June 28, 2003 condensed consolidated balance sheet was derived from the Company's audited consolidated financial statements.

See accompanying notes to condensed consolidated financial statements.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**(in thousands, except per share amounts)
(Unaudited)

| | Quarter Ended | | Nine Months Ended | |
|--|-------------------|-------------------|-------------------|-------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Revenues: | | | | |
| Net sales | \$ 97,662 | \$ 95,846 | \$375,586 | \$348,618 |
| Royalty fees | 3,806 | 3,607 | 14,929 | 13,757 |
| Franchise fees | 80 | 80 | 568 | 355 |
| Total revenues | 101,548 | 99,533 | 391,083 | 362,730 |
| Expenses: | | | | |
| Cost of goods sold and occupancy costs | 71,432 | 70,164 | 250,465 | 230,563 |
| Company-owned stores operating and selling expense | 24,754 | 23,196 | 86,923 | 81,182 |
| Franchise expense | 2,024 | 1,755 | 5,245 | 4,963 |
| General and administrative expense | 8,506 | 7,223 | 24,163 | 22,928 |
| Litigation charge | 4,100 | | 4,100 | |
| Total expenses | 110,816 | 102,338 | 370,896 | 339,636 |
| Operating (loss) income | (9,268) | (2,805) | 20,187 | 23,094 |
| Interest income | (29) | (5) | (59) | (29) |
| Interest expense | 108 | 213 | 450 | 3,946 |
| Interest expense, net | 79 | 208 | 391 | 3,917 |
| (Loss) income before income taxes | (9,347) | (3,013) | 19,796 | 19,177 |
| (Benefit) provision for income taxes | (3,786) | (1,205) | 8,017 | 7,671 |
| Net (loss) income | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| Basic (loss) earnings per share | \$ (0.33) | \$ (0.11) | \$ 0.70 | \$ 0.69 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Weighted average shares outstanding basic | 16,992 | 16,653 | 16,871 | 16,617 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Diluted (loss) earnings per share | \$ (0.33) | \$ (0.11) | \$ 0.60 | \$ 0.58 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Weighted average shares outstanding diluted | 16,992 | 16,653 | 19,630 | 19,757 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

See accompanying notes to condensed consolidated financial statements.

Table of Contents**PARTY CITY CORPORATION AND SUBSIDIARY****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**(in thousands)
(Unaudited)

| | Nine Months Ended | |
|---|---------------------------|--------------------------------------|
| | March 27, 2004 | March 29, 2003 |
| | | (As Restated See Note 12) |
| Cash flow from operating activities: | | |
| Net income | \$ 11,779 | \$ 11,506 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 12,306 | 11,092 |
| Non-cash interest and financing costs | 120 | 1,584 |
| Deferred rent | (326) | 558 |
| Stock-based compensation | 418 | 799 |
| Provision for doubtful accounts | (82) | (460) |
| Other | 13 | |
| Changes in assets and liabilities: | | |
| Merchandise inventory | 4,804 | (19,882) |
| Accounts payable, accrued expenses and other current liabilities | 3,438 | 8,253 |
| Other long-term liabilities | (119) | (95) |
| Other current assets and other assets | 2,456 | (2,026) |
| | <hr/> | <hr/> |
| Net cash provided by operating activities | 34,807 | 11,329 |
| Cash flow from investing activities: | | |
| Purchases of property and equipment | (8,638) | (15,023) |
| Stores acquired | | (1,758) |
| Proceeds from disposals of property and equipment | | 144 |
| | <hr/> | <hr/> |
| Net cash used in investing activities | (8,638) | (16,637) |
| Cash flow from financing activities: | | |
| Net (payments on) proceeds from Loan Agreement | (11,229) | 18,637 |
| Cash overdrafts | (4,021) | (443) |
| Proceeds from exercise of stock options and warrants | 1,482 | 1,525 |
| Payments of senior notes | | (10,207) |
| Payments of financing costs | | (524) |
| Purchase of treasury stock | | (4,111) |
| | <hr/> | <hr/> |

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| | | |
|---|-------------------|-------------------|
| Net cash (used in) provided by financing activities | (13,768) | 4,877 |
| | <u> </u> | <u> </u> |
| Net increase (decrease) in cash and cash equivalents | 12,401 | (431) |
| Cash and cash equivalents, beginning of period | 3,372 | 3,467 |
| | <u> </u> | <u> </u> |
| Cash and cash equivalents, end of period | \$ 15,773 | \$ 3,036 |
| | <u> </u> | <u> </u> |
| Supplemental disclosure of cash flow information: | | |
| Income taxes paid | \$ 7,707 | \$ 9,476 |
| Interest paid | 330 | 2,758 |
| Supplemental disclosure of non-cash financing activity: | | |
| Issuance of shares under employment stock plan | \$ 244 | \$ 265 |
| Issuance of shares under management stock plan | 99 | 288 |
| Issuance of warrants | | 245 |

See accompanying notes to condensed consolidated financial statements.

Table of Contents

PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation

The condensed consolidated financial statements are unaudited. In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments (consisting only of normal recurring accruals) necessary to present fairly the financial position of Party City Corporation and its consolidated subsidiary (the Company) as of March 27, 2004 and March 29, 2003 and the results of operations for the quarters and nine months ended March 27, 2004 and March 29, 2003 and cash flows for the nine months ended March 27, 2004 and March 29, 2003. Because of the seasonality of the party goods industry, operating results of the Company on a quarterly or nine-month basis may not be indicative of operating results for the full fiscal year.

These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended June 28, 2003, which are included in the Company's Annual Report on Form 10-K with respect to such period filed with the Securities and Exchange Commission on September 26, 2003. All significant intercompany accounts and transactions have been eliminated. The June 28, 2003 condensed consolidated balance sheet amounts included herein are derived from the Company's audited consolidated financial statements.

Our Fiscal Year (Fiscal Year) refers to the 52 or 53 weeks, as applicable, ending the Saturday nearest to June 30. The year ended July 3, 2004 (Fiscal 2004) is a 53 week year as compared to the years ended June 28, 2003 (Fiscal 2003) and June 29, 2002 (Fiscal 2002), which were each 52 week years.

Certain reclassifications have been made to the condensed consolidated financial statements in prior periods to conform to the current period presentation.

2. Accounting Policies

The Company's significant accounting policies are described in the footnotes to the financial statements in its Annual Report on Form 10-K. Additional policies are presented below:

Vendor allowances. The Company and certain vendors have arrangements whereby the vendors provide merchandise allowances based on purchases. Generally, these arrangements provide for a fixed percentage discount to be provided to the Company. Because the arrangements provide for concessions to be based on the level of purchases from the vendor, we account for the allowances from the vendor as a reduction of inventory cost.

The Company also receives vendor allowances as reimbursement for advertising. Advertising allowances are recorded as reductions to advertising expense as they do not affect inventory or gross margin. These allowances represent reimbursements of specific, incremental, identifiable costs incurred by the Company in selling the vendor's product and therefore are characterized as a reduction of that cost when recognized in the income statement.

Operating leases. The Company's rent expense under operating leases provides for step rent provisions, escalation clauses, capital improvement funding and other lease concessions as applicable in each lease. The minimum lease payments are recognized on a straight-line basis over the term of each individual underlying lease.

Advertising. Advertising costs, including print and other media advertising, are expensed as incurred.

3. Stock-Based Compensation

The Company periodically grants stock options to employees. Pursuant to Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, the Company accounts for stock-based employee compensation arrangements using the intrinsic value method. If the options are granted to employees below fair market value, compensation expense is recognized. The Company has adopted the disclosure only provisions of Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock Based Compensation - Transition and Disclosure, an Amendment of SFAS No. 123*. If compensation cost for the Company's stock option plans had been determined in accordance with the fair value method prescribed by SFAS No. 123, the Company's net income (loss) would have been (in thousands, except per share data):

Table of Contents

| | Quarter Ended | | Nine Months Ended | |
|--|---------------------------|---------------------------|---------------------------|---------------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Net (loss) income as reported | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |
| Add: Stock-based employee compensation expense determined under APB 25, net of tax | 161 | 28 | 249 | 479 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method, net of tax | (533) | (255) | (1,526) | (1,410) |
| Pro-forma net (loss) income | <u>\$ (5,933)</u> | <u>\$ (2,035)</u> | <u>\$ 10,502</u> | <u>\$ 10,575</u> |
| Basic and diluted earnings per share: | | | | |
| Basic (loss) earnings per share as reported | \$ (0.33) | \$ (0.11) | \$ 0.70 | \$ 0.69 |
| Basic (loss) earnings per share pro forma | \$ (0.35) | \$ (0.12) | \$ 0.62 | \$ 0.64 |
| Diluted (loss) earnings per share as reported | \$ (0.33) | \$ (0.11) | \$ 0.60 | \$ 0.58 |
| Diluted (loss) earnings per share pro forma | \$ (0.35) | \$ (0.12) | \$ 0.53 | \$ 0.54 |

The weighted average fair value of options granted during the third quarter of Fiscal 2004 and 2003 was \$5.56 and \$6.95, respectively.

The weighted average fair value of options granted during the nine months ended Fiscal 2004 and 2003 was \$5.55 and \$7.41, respectively.

4. Earnings Per Share

The following table sets forth the computations of basic and diluted earnings per share (in thousands, except per share amounts):

| | Quarter Ended | | Nine Months Ended | |
|--|---------------------------|---------------------------|---------------------------|---------------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Net (loss) income | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |
| Earnings per share basic | \$ (0.33) | \$ (0.11) | \$ 0.70 | \$ 0.69 |
| Earnings per share diluted | \$ (0.33) | \$ (0.11) | \$ 0.60 | \$ 0.58 |
| Weighted average common shares outstanding | 16,992 | 16,653 | 16,871 | 16,617 |
| Dilutive effect of stock options | (a) | (b) | 454 (c) | 692 (c) |
| Dilutive effect of warrants | (a) | (b) | 2,286 | 2,359 |

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| | | | | |
|--|--------|--------|--------|--------|
| Restricted stock units | (d) | (d) | 19 | 89 |
| | _____ | _____ | _____ | _____ |
| Weighted average common and potentially dilutive common shares outstanding | 16,992 | 16,653 | 19,630 | 19,757 |
| | _____ | _____ | _____ | _____ |

- (a) Options to purchase 2,958,123 common shares at prices ranging from \$1.71 to \$30.88 per share and warrants to purchase 2,496,000 common shares at \$1.07 per share were outstanding at March 27, 2004 but were not included in the computation of diluted loss per share for the quarter ended March 27, 2004 because to do so would have been anti-dilutive.
- (b) Options to purchase 1,652,825 common shares at prices ranging from \$2.00 to \$32.50 per share and warrants to purchase 2,496,000 common shares at \$1.07 per share were outstanding at March 29, 2003 but were not included in the computation of diluted loss per share for the quarter ended March 29, 2003 because to do so would have been anti-dilutive.
- (c) Options to purchase 719,637 common shares at prices ranging from \$12.91 to \$32.50 and options to purchase 649,879 common shares at prices ranging from \$12.53 to \$32.50 were outstanding at March 27, 2004 and March 29, 2003, respectively, but were not included in the computation of diluted earnings per share for the nine months ended March 27, 2004 and March 29, 2003, respectively, because to do so would have been anti-dilutive.
- (d) Restricted stock units of 16,012 and 84,052 shares of common stock were outstanding at March 27, 2004 and March 29, 2003, respectively, related to the Management Stock Purchase Plan and were not included in the computation because to do so would have been anti-dilutive.

Table of Contents**5. Financing Agreement**

In January 2003, the Company entered into a \$65 million revolving credit facility (Loan Agreement) with Wells Fargo Retail Finance, LLC, as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent. Under the terms of the Loan Agreement, the Company may borrow amounts based on a percentage of its eligible inventory and credit card receivables, subject to certain borrowing conditions and customary sub-limits, reserves and other limitations. Interest on each advance is charged, at the Company's option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50%, and is currently at 1.25%, per annum or (ii) at the prime rate less the applicable margin, which was initially set at and is currently 0.25% per annum (totaling 3.75% at March 27, 2004). The term of the Loan Agreement is through April 30, 2006 and is secured by a lien on substantially all of the Company's assets. Pursuant to the terms of the Loan Agreement, the Company had a standby letter of credit of \$3.7 million outstanding at March 27, 2004. At March 27, 2004 and May 3, 2004, the Company had no borrowings outstanding under the Loan Agreement. Based on a percentage of current eligible inventory and credit card receivables, the Company had \$23.4 million available to be borrowed under the Loan Agreement at May 3, 2004.

6. Stockholders' Equity***Shares Outstanding***

The Company's authorized capital stock was increased from 25,000,000 shares to 40,000,000 shares of its common stock, \$0.01 par value per share, at the annual shareholders' meeting on November 12, 2003. At March 27, 2004 and March 29, 2003, there were 17,760,444 shares and 17,177,151 shares, respectively, of the Company's common stock issued. At March 27, 2004 and March 29, 2003, there were 747,012 shares of the Company's common stock held as treasury stock. At March 27, 2004 and March 29, 2003, there were 17,013,432 shares and 16,430,139 shares, respectively, of the Company's common stock outstanding.

Stock Repurchase

In September 2001, the Board of Directors authorized the Company to repurchase up to \$15 million of its outstanding common stock. Stock repurchases are made at the discretion of management. There was no stock repurchase activity during the first nine months of Fiscal 2004. During the first nine months of Fiscal 2003, the Company purchased 463,012 shares for an aggregate amount of \$4.1 million. As of March 27, 2004, the Company had purchased 747,012 shares for an aggregate amount of \$5.9 million or 39.6% of the total amount to be purchased.

Warrants

There were no warrant exercises in the first nine months of Fiscal 2004. In the first nine months of Fiscal 2003, 688,000 warrants to purchase the Company's common stock were exercised. This included a cash exercise of 458,667 warrants pursuant to which the Company received proceeds of \$490,774 and a cashless exercise of the remaining 229,333 warrants pursuant to which the warrant holders surrendered 15,541 shares and received 213,792 shares of the Company's common stock. The 15,541 shares of the Company's common stock surrendered had a market value of \$245,386 at the time of surrender.

Management Stock Purchase Plan

In June 2001, the Company established a Management Stock Purchase Plan (MSPP). The MSPP is designed to provide a means by which the Company may attract highly qualified persons to enter into and remain in the employment of the Company. The MSPP provides certain management employees of the Company the opportunity to defer a portion of their compensation to acquire and maintain ownership of the Company's common stock, with the

intent to strengthen their commitment to the welfare of the Company and to promote an identity of interest among Company stockholders and these employees. The amount deferred by the individual is held in restricted stock units. The restricted stock units are converted into the Company's common stock on a one-to-one basis upon vesting. These restricted stock units are purchased at a discount of 20% or 25%, depending on the amount of the individual deferral, from the average price of Company's common stock on the determination date. Such discounts vest at the end of three years or seven years, selected by the participant, after the determination date. The amortization of the discount is charged to compensation expense over the deferral period. The compensation expense attributable to the MSPP for the nine months ended Fiscal 2004 and Fiscal 2003 was \$19,000 and \$114,000, respectively, resulting in the obligation to issue 16,012 and 84,052 shares of common stock, respectively, upon vesting and conversion.

Employee Stock Purchase Plan

In June 2001, the Company established an Employee Stock Purchase Plan (ESPP). The ESPP provides employees of the Company with an opportunity to purchase shares of the Company's common stock at a discount of 15% through accumulated payroll

Table of Contents

deductions. This plan qualifies as an Employee Stock Purchase Plan under Section 423 of the Internal Revenue Code. Contributions to the plan during the first nine months of Fiscal 2004 and 2003 were approximately \$254,000 and \$349,000, resulting in the obligation to issue 29,072 and 34,447 shares of common stock, respectively.

7. Legal Proceedings

A lawsuit was filed on September 25, 2001 against Party City Corporation in Los Angeles Superior Court by an assistant manager in one of the Company's California stores for himself and on behalf of other members of an alleged class of Party City store managers (the Class) who claim the Company misclassified the Class members as exempt from California overtime wage and hour laws. The Class members sought the disgorgement of overtime wages allegedly owed by the Company to them but not paid and they also sought punitive damages and statutory penalties.

On March 30, 2004, the parties reached an agreement-in-principle to settle this lawsuit for \$5.5 million on a claims made basis, which means that a payout to class members will only occur when claims are actually made by Class members. Previously, the Company recorded a pre-tax charge of \$1.4 million related to this lawsuit. In connection with the agreement-in-principle, the Company recorded an additional pre-tax charge of \$4.1 million during the third quarter of Fiscal 2004 to fully cover the settlement payments, attorneys' fees and the estimated expenses of administering the settlement. The settlement provided for pursuant to the agreement-in-principle is subject to certain conditions, including the negotiation and execution of a definitive settlement agreement and the approval of the terms of the definitive settlement agreement by the Superior Court after notice to the members of the class who have the right to object. There can be no assurance that all of these conditions will be satisfied. If a final settlement is not consummated and the lawsuit is continued, a class is certified, liability is found and a judgment is entered, such judgment may adversely affect the Company.

In addition to the foregoing, from time to time the Company is involved in routine litigation incidental to the conduct of the business, which is not, individually or in the aggregate, material to the Company.

Table of Contents**8. Segment Information**

The Company owns, operates and franchises party supplies stores in the United States. The Company's management reporting system evaluates performance based on a number of factors; however, the primary measure of performance is the pre-tax operating profit of each segment. Accordingly, the Company reports two segments—retail and franchising. The retail segment generates revenue primarily through the sale of third-party branded party goods through Company-owned stores. The franchising segment generates revenue through the imposition of an initial one-time franchise fee which is paid upon the grant of a new franchise and ongoing royalty payments by franchisees based on retail sales. The accounting policies are described in the general accounting policies section included in the Company's 10-K for the year ended June 28, 2003 and in Note 2 herein. The Company has no inter-segment sales. No single customer accounts for 10% or more of total revenues. All assets of the Company are located in the United States. The following table contains key financial information of the Company's business segments (in thousands):

| | Quarter Ended | | Nine Months Ended | |
|--|-------------------|-------------------|-------------------|-------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Retail: | | | | |
| Net sales | \$ 97,662 | \$ 95,846 | \$375,586 | \$348,618 |
| Cost of goods sold and occupancy costs | 71,432 | 70,164 | 250,465 | 230,563 |
| Gross profit | 26,230 | 25,682 | 125,121 | 118,055 |
| Store operating and selling expense | 24,754 | 23,196 | 86,923 | 81,182 |
| Company-owned stores profit contribution | 1,476 | 2,486 | 38,198 | 36,873 |
| General and administrative expense | 8,506 | 7,223 | 24,163 | 22,928 |
| Litigation charge | 4,100 | | 4,100 | |
| Company-owned (loss) profit | \$ (11,130) | \$ (4,737) | \$ 9,935 | \$ 13,945 |
| Identifiable assets | \$167,283 | \$175,092 | \$167,283 | \$175,092 |
| Depreciation/amortization | 4,614 | 3,959 | 12,306 | 11,092 |
| Capital expenditures | 5,109 | 1,579 | 8,638 | 16,781 |
| Franchise: | | | | |
| Royalty fees | \$ 3,806 | \$ 3,607 | \$ 14,929 | \$ 13,757 |
| Franchise fees | 80 | 80 | 568 | 355 |
| Total franchise revenue | 3,886 | 3,687 | 15,497 | 14,112 |
| Total franchise expense | 2,024 | 1,755 | 5,245 | 4,963 |

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| | | | | |
|--------------------------------------|------------|------------|-----------|-----------|
| Franchise profit contribution | \$ 1,862 | \$ 1,932 | \$ 10,252 | \$ 9,149 |
| Identifiable assets | \$ 2,137 | \$ 1,675 | \$ 2,137 | \$ 1,675 |
| Depreciation/amortization | | | | |
| Capital expenditures | | | | |
| Total Company: | | | | |
| Total revenues | \$101,548 | \$ 99,533 | \$391,083 | \$362,730 |
| Operating (loss) income | \$ (9,268) | \$ (2,805) | \$ 20,187 | \$ 23,094 |
| Interest expense, net | 79 | 208 | 391 | 3,917 |
| (Loss) income before income taxes | (9,347) | (3,013) | 19,796 | 19,177 |
| (Benefit) provision for income taxes | (3,786) | (1,205) | 8,017 | 7,671 |
| Net (loss) income | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |
| Identifiable assets | \$169,420 | \$176,767 | \$169,420 | \$176,767 |
| Depreciation/amortization | 4,614 | 3,959 | 12,306 | 11,092 |
| Capital expenditures | 5,109 | 1,579 | 8,638 | 16,781 |

Table of Contents**9. Acquisitions and Dispositions of Stores**

During Fiscal 2003, the Company acquired two stores from a franchisee. The aggregate consideration paid in connection with this acquisition was \$1,603,000. The consolidated balance sheets include allocations of the purchase price related to this transaction of approximately \$1,002,000 in goodwill, \$195,000 in fixed assets and \$406,000 in inventory.

In Fiscal 2002, the Company completed the acquisition of thirteen stores in the Seattle, Washington market from Paper Warehouse, Inc. The conversion of these locations to the Party City store format was completed and all stores were opened by the first quarter of Fiscal 2003. Additional goodwill of \$155,000 was recorded in Fiscal 2003 related to the completion of the conversion of these locations.

The acquisitions have been accounted for under the purchase method of accounting. The results of operations of the acquired stores are included in the financial statements from the date the stores were opened. The favorable real estate locations and market share obtained in the aforementioned transactions resulted in goodwill premiums paid. Such items continue to provide sufficient return on the premium invested.

The purchase price of these acquisitions was determined by applying a multiple to the acquired company's proforma earnings before depreciation, amortization, and taxes. The multiple the Company uses has generally resulted in an acceptable return on our investment compared to the opening of a new site as the customer and sales base is established.

There were no changes in the carrying amount of goodwill of \$18.6 million (all within our retail segment) for the nine months ended March 27, 2004.

Assuming the stores acquired during the nine months ended March 29, 2003 were acquired on June 30, 2002, the beginning of Fiscal 2003, the pro forma results would have been as follows (in thousands, except per share amounts):

| | Quarter Ended | | Nine Months Ended | |
|-----------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Net sales | \$97,662 | \$95,846 | \$375,586 | \$350,067 |
| Net (loss) income | (5,561) | (1,808) | 11,779 | 11,583 |
| (Loss) earnings per share basic | \$ (0.33) | \$ (0.11) | \$ 0.70 | \$ 0.70 |
| (Loss) earnings per share diluted | (0.33) | (0.11) | 0.60 | 0.59 |

10. Guarantees

In November 2002, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 45, Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. The Interpretation elaborates on the existing disclosure requirements for most guarantees, including loan guarantees such as standby letters of credit. It also clarifies that at the time a company issues a guarantee, the company must recognize an initial liability for the fair value, or market value, of the obligations it assumes under the guarantee and must disclose that information in its interim and annual financial statements. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations do not apply to product warranties or to guarantees accounted for as derivatives. The initial recognition and initial measurement provisions

apply on a prospective basis to guarantees issued or modified after December 31, 2002.

The Company has unconditionally guaranteed the lease payments of 24 leases associated with franchise stores and the payment of sublease rentals by subleasees under four subleases where the Company is the sublessor. The majority of the guarantees were given when the Company sold stores in 1999 as part of its restructuring. The guarantees continue until the expiration date of the leases, which range from 2004 through 2011. The maximum amount of the guarantees may vary, but is limited to the sum of the total amount due under the lease. As of March 27, 2004, the maximum aggregate amount of the guarantees was approximately \$17.2 million.

Table of Contents**11. Recent Accounting Standards**

FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of APB No. 50 (FIN 46), was issued in January 2003, as amended by FIN 46-R. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The provisions of FIN 46 must be applied no later than the first reporting period ending after March 15, 2004. The Company does not currently participate in any variable interest entities.

12. Restatement of Statement of Cash Flows

Subsequent to the issuance of the condensed consolidated financial statements for the period ended March 29, 2003 the Company determined that the cash flow related to the Company's cash overdraft should have been classified as a financing activity rather than an operating activity. As a result, the condensed consolidated statement of cash flows for the nine months ended March 29, 2003 has been restated to reflect the cash flows related to the Company's cash overdraft as a financing activity rather than an operating activity. A summary of the effect of the restatement on cash flows provided by operating and financing activities is as follows (in thousands):

| Nine months ended March 29, 2003 | As Previously | As |
|---|--------------------------|-----------------|
| | Reported | Restated |
| Operating Activities: | \$ 10,886 | \$ 11,329 |
| Financing Activities | \$ 5,320 | \$ 4,877 |

Table of Contents

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Introduction

We operate retail party supplies stores within the continental United States and we sell franchises on an individual store and area franchise basis throughout the United States and Puerto Rico. At March 27, 2004, our network consisted of 503 stores, with 249 stores owned by us and 254 stores owned by franchisees. We report two segments retail and franchising. The retail segment generates revenue primarily through the sale of third-party branded party goods through Company-owned stores. The franchising segment generates revenue through the imposition of an initial one-time franchise fee and ongoing royalty payments based on retail sales.

Traditionally, the retail party supplies business has been fragmented, with consumers purchasing party-related products from single owner-operated party supplies stores and designated departments in drug stores, general mass merchandisers, supermarkets and department stores of local, regional and national chains. We seek to offer customers a one-stop party store that provides a wide selection of merchandise at a compelling value and in sufficient quantities to satisfy customer needs for parties of virtually all sizes and types.

We continually strive to improve customer satisfaction and strengthen our financial condition. We have recently undertaken various initiatives to make fundamental improvements in our business, profitability and cash flows. These initiatives have primarily focused on our: breadth and quality of products; product pricing; financial, distribution and inventory systems; and employee base.

With respect to our products, we are developing proprietary processes to evaluate and select our product assortments more efficiently and effectively. We are also reconfiguring our in-store product layout to better align product themes and facilitate an easier shopping experience for our customers.

Additionally, we continue to make advances in our inventory reduction initiative. Our SKU reduction, vendor rationalization and product allocation strategies have facilitated an average per store inventory reduction of 22% over the prior year and are the principal reason for the increase in our cash and cash equivalents from \$3.0 million at March 29, 2003 to \$15.8 million at March 27, 2004. This inventory reduction has also resulted in an increase of inventory turnover. We believe these strategies will continue to provide us with the flexibility needed to provide fresh merchandise choices to our customers and still maintain a sufficient variety and quantity of products to satisfy customer needs.

We have also focused on enhancing our enterprise systems, with the upgrade of our store and corporate systems on target to be fully implemented by July 2004. The investment in our enterprise systems has improved certain store processes, and will provide the systemic foundation for our logistics initiative. Working with our vendor partners and third-party logistics providers, we are embarking on enhancements that will further drive product in-stock positions and lower our supply-chain network costs.

Underlying these and other important initiatives are key investments we have made in our employee base, including the implementation of training programs related to customer service. Over the last several weeks, we have appointed a chief merchant, a position that remained open for eight months. Further, to develop the staffing infrastructure needed to support our key initiatives regarding product and product flow, we have hired several buying and merchandise managers and two logistics managers.

Since the implementation of these initiatives, we have generated significant upfront investment expenses that are disproportionate to our sales performance. However, we anticipate these expenses will normalize over time. Most importantly, these investment initiatives are anticipated to improve customer experience and solidify brand

recognition which we believe will ultimately result in increased sales, reduced expenses and, accordingly, greater net income. Should our customers respond less favorably to our merchandise offerings, we may need to respond by taking markdowns. If we have to reduce our prices, margins will correspondingly decrease, thus reducing our net income.

Table of Contents**Key Performance Indicators and Statistics**

We use a number of key indicators of financial condition and operating results to evaluate the performance of our business, including the following:

| | Quarter Ended | | Nine Months Ended | |
|---|-------------------|-------------------|-------------------|-------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Net sales (in thousands) | \$97,662 | \$95,846 | \$375,586 | \$348,618 |
| Total Company-owned store count | 249 | 241 | 249 | 241 |
| Average net sales per same store – current period (in thousands) | \$ 398 | \$ 426 | \$ 1,544 | \$ 1,583 |
| Same store retail transactions (a) (in thousands) | 5,373 | 5,486 | 18,554 | 18,479 |
| Same store average net sale per retail transaction | \$ 17.58 | \$ 17.37 | \$ 19.06 | \$ 18.66 |
| Same store net sales growth | (0.9%) | (2.4%) | 2.5% | 1.1% |
| Gross profit as a percent of net sales | 26.9% | 26.8% | 33.3% | 33.9% |
| Store profit contribution as a percent of net sales | 1.5% | 2.6% | 10.2% | 10.6% |
| Diluted (loss) earnings per share | \$ (0.33) | \$ (0.11) | \$ 0.60 | \$ 0.58 |
| EBITDA(b) (in thousands) | \$ (4,654) | \$ 1,154 | \$ 32,493 | \$ 34,186 |

(a) Retail transactions represent each time a customer makes a purchase at the register.

(b) see EBITDA discussion on page 23.

For further discussion of these key indicators, see Results of Operations beginning on page 17.

The following table shows the growth in our network of Company owned and franchise stores for the third quarter and nine months ended March 27, 2004 and March 29, 2003 :

| | Quarter Ended | | Nine Months Ended | |
|------------------------------------|----------------------|----------------------|----------------------|----------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Store Data: | | | | |
| Company-owned: | | | | |
| Stores open at beginning of period | 247 | 239 | 242 | 209 |
| Stores opened | 2 | 3 | 8 | 31 |
| Stores closed | | (1) | (1) | (1) |
| Stores acquired from franchisees | | | | 2 |
| | — | — | — | — |
| Stores open at end of period | 249 | 241 | 249 | 241 |

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| | | | | |
|---|------------|------------|------------|------------|
| | — | — | — | — |
| Average Company-owned stores open in period | 248 | 240 | 247 | 233 |
| (Decrease) increase in Company-owned same store sales | (0.9%) | (2.4%) | 2.5% | 1.1% |
| Franchise: | | | | |
| Stores open at beginning of period | 254 | 240 | 241 | 242 |
| Stores opened | 2 | 1 | 15 | 9 |
| Stores closed | (2) | | (2) | (8) |
| Stores sold to Company | | | | (2) |
| Stores open at end of period | 254 | 241 | 254 | 241 |
| Average franchise stores open in period | 253 | 240 | 251 | 244 |
| Total stores chain wide | 503 | 482 | 503 | 482 |
| Increase in franchise same store sales | 1.3% | 1.7% | 4.5% | 3.3% |

Table of Contents

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires the appropriate application of certain accounting policies, many of which require estimates and assumptions about future events and their impact on amounts reported in the financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the consolidated financial statements.

We believe our application of accounting policies, and the estimates inherently required by the policies, are reasonable. These accounting policies and estimates are constantly reevaluated and adjustments are made when facts and circumstances dictate a change. Historically, we have found our application of accounting policies to be appropriate and actual results generally do not differ materially from those determined using necessary estimates.

Our accounting policies are more fully described in Note 1 to the consolidated financial statements contained in our Annual Report on Form 10-K filed with the Securities and Exchange Commission (SEC) on September 26, 2003. We have identified certain critical accounting policies that are described below.

Merchandise inventory. Inventory is valued using the cost method which values inventory at the lower of the actual cost or market, at the individual item level. Cost is determined using the weighted average method. Inventory levels are reviewed to identify slow-moving and closeout merchandise that will no longer be carried. Market is determined by the estimated net realizable value, based upon the merchandise selling price.

Finite long-lived assets. In the evaluation of the fair value and future benefits of finite long-lived assets, we perform an analysis of the anticipated undiscounted future net cash flows of the related finite long-lived assets. Various factors including future sales growth and profit margins are included in this analysis. To the extent these future projections or strategies change, the conclusion regarding impairment may differ from the current estimates.

Insurance accruals. Our consolidated balance sheets include liabilities with respect to self-insured workers compensation and general liability claims. We estimate the required liability of such claims utilizing an actuarial method, based upon various assumptions, which include, but are not limited to, our historical loss experience, projected loss development factors, actual payroll and other data. The required liability is also subject to adjustment in the future based upon changes in claims experience, including changes in the number of incidents (frequency) and changes in the ultimate cost per incident (severity).

Goodwill. All of our goodwill is associated with our retail segment. We evaluate goodwill annually or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flows. In making this assessment, management relies on a number of factors including operating results, business plans, economic projections, anticipated future cash flows and marketplace data. A change in these underlying assumptions may cause a change in the results of the tests and, as such, could cause fair value to be less than the carrying value. In such event, we would then be required to record a charge, which would impact earnings.

Sales Returns. We estimate future sales returns and, when material, record a provision in the period that the related sales are recorded based on historical information. Should actual returns differ from our estimates, we would be required to revise estimated sales returns.

Store Closure Costs. We record estimated store closure costs, such as estimated lease commitment costs net of estimated sublease income and other miscellaneous store closing costs, when the liability is incurred. Such estimates may be subject to change should actual costs differ.

Table of Contents

General Definitions for Operating Results

Net Sales. Net sales include same store net sales and new store net sales. Same store net sales include net sales for those stores that were in operation for a full period in both the current month and the corresponding month for the prior year. New store net sales include net sales in the current fiscal year from stores opened during the previous fiscal year before they are considered same stores, and new stores opened in the current fiscal year.

Cost of goods sold and occupancy costs. Cost of goods sold and occupancy costs includes the cost of merchandise, freight to the stores and store occupancy costs. Store occupancy costs include rent, common area maintenance, real estate taxes, repairs and maintenance, depreciation, insurance and utilities.

Gross profit. Gross profit is net sales minus cost of goods sold and occupancy costs.

Store operating and selling expenses. Store operating and selling expenses consist of selling and store management payroll, employee benefits, medical insurance, employment taxes, advertising, other store level expenses and pre-opening expenses which are expensed when incurred.

Company-owned store profit contribution. Company-owned store profit contribution is gross profit minus store operating and selling expenses.

General and administrative expenses. General and administrative expenses include payroll and employee benefits, employment taxes, management information systems, marketing, insurance, legal and other corporate level expenses. Corporate level expenses are primarily attributable to our corporate office in Rockaway, New Jersey, and district and regional offices throughout the country.

Franchising. Franchising revenue is composed of the initial franchise fees, which are recorded as revenue when a franchise store opens, plus ongoing royalty fees, which are generally 4.0% of the store's net sales. Franchise expenses include direct and indirect expenses. The direct expenses include salaries, travel and other direct expenses of the franchise operations department in addition to legal fees, bad debt expense, insurance expense and other miscellaneous charges. The indirect expenses include pro-rata allocations of corporate expenses for salaries, including bonuses, occupancy and depreciation, based on time spent on franchise support.

Franchise profit contribution. Franchise profit contribution is franchise revenue minus franchise expenses.

Interest expense. Interest expense includes interest relating to our senior notes and credit facility. Interest also includes amortization of financing intangibles, bank service charges and interest on capital lease obligations.

Table of Contents**Results of Operations**

The following table sets forth the results of operations, and also expresses the results of operations as a percentage of segment revenues and total revenues, for the periods indicated (in thousands, except per share amounts):

| | Quarter Ended | | | |
|--|---------------------------|-------------------|---------------------------|-------------------|
| | March 27, 2004 | | March 29, 2003 | |
| Statement of Operations Data: | | | | |
| Company-owned stores: | | | | |
| Net sales | \$ 97,662 | 100.0% | \$95,846 | 100.0% |
| Cost of goods sold and occupancy costs | 71,432 | 73.1 | 70,164 | 73.2 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Gross profit | 26,230 | 26.9 | 25,682 | 26.8 |
| Store operating and selling expense | 24,754 | 25.3 | 23,196 | 24.2 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Company-owned stores profit contribution | 1,476 | 1.5 | 2,486 | 2.6 |
| General and administrative expense | 8,506 | 8.7 | 7,223 | 7.5 |
| Litigation charge | 4,100 | 4.2 | <u> </u> | <u> </u> |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Company-owned loss | (11,130) | (11.4) | (4,737) | (4.9) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Franchise stores: | | | | |
| Royalty fees | 3,806 | 97.9 | 3,607 | 97.8 |
| Franchise fees | 80 | 2.1 | 80 | 2.2 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Total franchise revenues | 3,886 | 100.0 | 3,687 | 100.0 |
| Total franchise expense | 2,024 | 52.1 | 1,755 | 47.6 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Franchise profit contribution | 1,862 | 47.9 | 1,932 | 52.4 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Operating loss | (9,268) | (9.1) | (2,805) | (2.8) |
| Interest expense, net | 79 | 0.1 | 208 | 0.2 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Loss before income taxes | (9,347) | (9.2) | (3,013) | (3.0) |
| Benefit for income taxes | (3,786) | (3.7) | (1,205) | (1.2) |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |

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| | | | | |
|---|------------|--------|------------|--------|
| Net loss | \$ (5,561) | (5.5%) | \$ (1,808) | (1.8%) |
| Basic loss per share | \$ (0.33) | | \$ (0.11) | |
| Diluted loss per share | \$ (0.33) | | \$ (0.11) | |
| Weighted average shares outstanding basic | 16,992 | | 16,653 | |
| Weighted average shares outstanding diluted | 16,992 | | 16,653 | |

Nine Months Ended

| | March 27, 2004 | | March 29, 2003 | |
|--|---------------------------|--------|---------------------------|--------|
| Statement of Operations Data: | | | | |
| Company-owned stores: | | | | |
| Net sales | \$375,586 | 100.0% | \$348,618 | 100.0% |
| Cost of goods sold and occupancy costs | 250,465 | 66.7 | 230,563 | 66.1 |
| Gross profit | 125,121 | 33.3 | 118,055 | 33.9 |
| Store operating and selling expense | 86,923 | 23.1 | 81,182 | 23.3 |
| Company-owned stores profit contribution | 38,198 | 10.2 | 36,873 | 10.6 |
| General and administrative expense | 24,163 | 6.4 | 22,928 | 6.6 |
| Litigation charge | 4,100 | 1.2 | | 0.0 |
| Company-owned profit | 9,935 | 2.6 | 13,945 | 4.0 |
| Franchise stores: | | | | |
| Royalty fees | 14,929 | 96.3 | 13,757 | 97.5 |
| Franchise fees | 568 | 3.7 | 355 | 2.5 |
| Total franchise revenues | 15,497 | 100.0 | 14,112 | 100.0 |
| Total franchise expense | 5,245 | 33.8 | 4,963 | 35.2 |
| Franchise profit contribution | 10,252 | 66.2 | 9,149 | 64.8 |

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| | | | | |
|---|-------------------|-------------------|-------------------|-------------------|
| Operating income | 20,187 | 5.2 | 23,094 | 6.4 |
| Interest expense, net | 391 | 0.1 | 3,917 | 1.1 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Income before income taxes | 19,796 | 5.1 | 19,177 | 5.3 |
| Provision for income taxes | 8,017 | 2.1 | 7,671 | 2.1 |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Net income | \$ 11,779 | 3.0% | \$ 11,506 | 3.2% |
| | <u> </u> | <u> </u> | <u> </u> | <u> </u> |
| Basic earnings per share | \$ 0.70 | | \$ 0.69 | |
| | <u> </u> | | <u> </u> | |
| Diluted earnings per share | \$ 0.60 | | \$ 0.58 | |
| | <u> </u> | | <u> </u> | |
| Weighted average shares outstanding basic | 16,871 | | 16,617 | |
| Weighted average shares outstanding diluted | 19,630 | | 19,757 | |

Table of Contents***Quarter Ended March 27, 2004 Compared to Quarter Ended March 29, 2003***

Retail. Net sales from Company-owned stores increased 1.9% to \$97.7 million for the third quarter of Fiscal 2004 from \$95.8 million for the third quarter of the prior fiscal year. The 1.9% increase in net sales resulted from an increase of 2.8% related to the stores that have not been open for one year, partially offset by a decrease of 0.9% from same-store net sales. The customer count in Company-owned stores, on a same store basis, decreased 2.1%, and the average net sale increased 1.2%. With six stores joining the same store sales group during the third quarter of Fiscal 2004, same store net sales increased 0.8% in the western region, 0.3% in the eastern region and decreased 3.4% in the central region. Same store net sales for Company-owned stores decreased 2.4% for the third quarter of Fiscal 2003. We opened two new stores and closed no stores during the third quarter of Fiscal 2004 and opened three new stores and closed one store in the same period last year.

Gross profit increased 2.1% to \$26.2 million in the third quarter of Fiscal 2004 from \$25.7 million in the same period last year. The increase was primarily due to increased net sales and reduced markdown activity, partially offset by increased occupancy and other costs. Gross margin as a percent of net sales was 26.9% for the third quarter of Fiscal 2004 compared with 26.8% for the same period last year. The chart below shows the components of the \$0.5 million increase in gross profit (in millions):

| Component | Portion of total change increase (decrease) |
|---------------------------|--|
| Net sales | \$ 0.5 |
| Merchandise | 0.9 |
| Occupancy and other costs | (0.9) |
| | <hr/> |
| Total | \$ 0.5 |

Store operating and selling expenses increased 6.7% to \$24.8 million for the third quarter of Fiscal 2004 from \$23.2 million in the same period last year. The increase in store operating and selling expenses is attributable to increased expenses related to the additional stores opened since the same period last year. The pre-opening expenses incurred in the third quarter of Fiscal 2004 for the new stores opened in this fiscal quarter and stores to be opened later in the fiscal year amounted to \$151,000 compared with \$57,000 incurred during the same period last year. Store operating and selling expenses were 25.3% and 24.2% of net sales for the third quarter of Fiscal 2004 and Fiscal 2003, respectively. The increase as a percent of net sales is due mainly to increases in payroll, advertising and other operating expenses relative to the increase in the number of stores and disproportionate sales growth. The chart below shows the components of the \$1.6 million increase in store operating and selling expenses (in millions):

| Component | Portion of total change increase (decrease) |
|-----------------------------|--|
| Net sales | \$ 0.4 |
| Payroll and fringe benefits | 0.3 |
| Advertising | 0.5 |

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| | |
|--|--------|
| Credit card, bank fees and other operating costs | 0.4 |
| | <hr/> |
| Total | \$ 1.6 |
| | <hr/> |

Company-owned store profit contribution was \$1.5 million for the third quarter of Fiscal 2004 compared with \$2.5 million for the same period last year. The decrease from the prior year is primarily the result of lower same store net sales and increased occupancy and store operating and selling expenses. Store profit contribution as a percent of net sales was 1.5% for the third quarter of Fiscal 2004 compared with 2.6% in the same period last year.

General and administrative expenses increased 17.8% to \$8.5 million for the third quarter of Fiscal 2004 from \$7.2 million in the same period last year. General and administrative expenses were 8.7% and 7.5% of net sales for the third quarter of Fiscal 2004 and Fiscal 2003, respectively. This increase is primarily due to increased corporate staffing to support our strategic initiatives, professional fees and training related to the implementation of our new information system, and professional fees for our logistics and Sarbanes-Oxley compliance initiatives. The chart below shows the components of the \$1.3 million increase in general and administrative expenses (in millions):

Table of Contents

| Component | Portion of total change increase (decrease) |
|--------------------------------|---|
| Corporate payroll | \$ 0.5 |
| Professional fees and training | 0.6 |
| Occupancy and other costs | 0.2 |
| | _____ |
| Total | \$ 1.3 |
| | _____ |

During this quarter, we recorded a pre-tax charge of \$4.1 million related to the settlement payments, attorneys fees and estimated expenses of administering the settlement of the lawsuit regarding California overtime wage and hour laws. See Note 7 in the condensed consolidated financial statements included herein.

Franchising. Franchise fees recognized on two store openings was \$80,000 in the third quarter of Fiscal 2004 and \$80,000 for two store openings in the same period last year. Royalty fees increased 5.5% to \$3.8 million in the third quarter of Fiscal 2004 from \$3.6 million in the same period last year. This was primarily due to an increased franchise store base of 13 stores and a same store sales increase of 1.3% for the franchise stores in the third quarter of Fiscal 2004.

Expenses attributable to the franchise segment increased 15.3% to \$2.0 million for the third quarter of Fiscal 2004 from \$1.8 million for the third quarter of Fiscal 2003. As a percentage of franchise revenue, franchise expenses were 52.1% and 47.6% for the third quarter of Fiscal 2004 and Fiscal 2003, respectively. This increase is due to increased staffing, corporate allocation and other franchise expenses resulting from new initiative costs, as previously discussed.

Franchise profit contribution decreased 3.6% to \$1.86 million in third quarter of Fiscal 2004 from \$1.93 million in the same period last year. The decrease in franchise profit contribution is due to an increase in franchise expenses, partially offset by the increase in royalty fees due to the increase franchise store base and same store net sales increase.

Interest Expense. Interest expense, net decreased to \$79,000 for the third quarter of Fiscal 2004 from \$208,000 in the same period last year. This decrease in interest expense is due to lower average borrowings during the quarter compared with the same time last year.

Income Taxes. An income tax benefit of \$3.8 million, or 40.5% of pre-tax income, and \$1.2 million, or 40.0% of pre-tax income, was recorded in the third quarter of Fiscal 2004 and Fiscal 2003, respectively. The change in tax rate from 40.0% to 40.5% is due to an increase in the overall state tax rate.

Net Income. As a result of the above factors, we recorded a net loss of \$5.6 million, or \$0.33 per basic and diluted share, in the third quarter of Fiscal 2004, as compared to a net loss of \$1.8 million, or \$0.11 per basic and diluted share, in the third quarter of Fiscal 2003. Weighted average diluted shares outstanding increased to 17.0 million in the third quarter of Fiscal 2004 from 16.7 million in the same period last year. This increase is mainly due to the warrant and stock option exercises during the twelve months ended March 27, 2004.

Nine Months Ended March 27, 2004 Compared with Nine Months Ended March 29, 2003

Retail. Net sales from Company-owned stores increased 7.7% to \$375.6 million for the nine-months ended March 27, 2004 from \$348.6 million for the same period last year. The 7.7% increase in net sales resulted from an increase of 5.2% related to the stores that have not been open for one year and an increase in same store net sales of 2.5%. The customer count in Company-owned stores, on a same store basis, increased 0.4%, and the average net sale increased 2.1%. With 37 stores joining the same store sales group during the nine months ended March 27, 2004, same store net sales increased 3.5% in the western region, 3.2% in the eastern region and 1.2% in the central region. Same store net sales for Company-owned stores increased 1.1% for the same period last year. We opened eight new stores and closed one store during the nine-months ended March 27, 2004 and opened 31 stores, acquired two stores from franchises and closed one store during the same period last year.

Gross profit increased 6.0% to \$125.1 million in the nine-months ended March 27, 2004 from \$118.1 million in the same period last year. The increase was primarily due to increased sales volume. Gross margin as a percent of sales was 33.3% for the nine-months ended March 27, 2004 compared with 33.9% for the same period last year. The decrease in gross profit as a percent of sales was related to a high level of promotional activity in July and August, the continued emphasis on the clearance of discontinued merchandise as part of the our strategic focus, and increased occupancy and other costs. The chart below shows the components of the \$7.0 million increase in gross profit (in millions):

Table of Contents

| Component | Portion of total change increase (decrease) |
|---------------------------|--|
| Net sales | \$ 9.2 |
| Merchandise | (1.3) |
| Occupancy and other costs | (0.9) |
| | <hr/> |
| Total | \$ 7.0 |
| | <hr/> |

Store operating and selling expenses increased 7.1% to \$86.9 million for the nine-months ended March 27, 2004 from \$81.2 million in the same period last year. The increase in store operating and selling expenses is attributable to increased expenses related to the additional stores opened since the same period last year. The pre-opening expenses incurred in the nine-months ended March 27, 2004 for the new stores and stores to be opened later in the fiscal year amounted to \$474,000 compared with \$853,000 incurred during the same time period last year. Store operating and selling expenses were 23.1% and 23.3% of sales for the nine-months ended March 27, 2004 and March 29, 2003, respectively. The decrease as a percent of sales is due mainly to a decrease in advertising and other operating expenses. The chart below shows the components of the \$5.7 million increase in store operating and selling expenses (in millions):

| Component | Portion of total change increase (decrease) |
|---|--|
| Net sales | \$ 6.3 |
| Payroll and fringe benefits | 0.6 |
| Advertising | (0.2) |
| Credit card, bank fees and other operating costs | (1.0) |
| | <hr/> |
| Total | \$ 5.7 |
| | <hr/> |

Company-owned store profit contribution was \$38.2 million for the nine-months ended March 27, 2004 compared with \$36.9 million for the same period last year. The improvement over the prior year is primarily the result of the increase in same store net sales and the number of stores. Store profit contribution as a percent of sales was 10.2% for the nine-months ended March 27, 2004 compared with 10.6% of sales in the same period last year due to the decrease in gross margin as described above.

General and administrative expenses increased 5.4% to \$24.2 million in the nine-months ended March 27, 2004 from \$22.9 million in the same period last year. General and administrative expenses were 6.4% and 6.6% of sales for the nine-months ended March 27, 2004 and March 29, 2003, respectively. This 5.4% increase is primarily due to increased corporate staffing, and our information systems, logistics and Sarbanes-Oxley compliance initiatives. The chart below shows the components of the \$1.3 million increase in general and administrative expenses (in millions):

| Component | Portion of total change increase (decrease) |
|--------------------------------|---|
| Corporate payroll | \$ 1.1 |
| Professional fees and training | 0.2 |
| | <hr/> |
| Total | \$ 1.3 |
| | <hr/> |

During the third quarter of Fiscal 2004, we recorded a pre-tax charge of \$4.1 million related to the settlement payments, attorneys fees and estimated expenses of administering the settlement of the lawsuit regarding California overtime wage and hour laws. See Note 7 in the condensed consolidated financial statements included herein.

Franchising. Franchising fees recognized on 15 store openings was \$568,000 in the nine-months ended March 27, 2004 as compared with \$355,000 recognized for nine store openings in the same period last year. Royalty fees increased 8.5% to \$14.9 million in the nine-months ended March 27, 2004 from \$13.8 million in the same period last year. This was primarily due to an increased franchise store base and a same store sales increase of 4.5% for the franchise stores in the nine-months ended March 27, 2004.

Expenses attributable to the franchise segment for the nine-months ended March 27, 2004 increased 5.7% to \$5.2 million from \$5.0 million for the same period last year. As a percentage of franchise revenue, franchise expenses were 33.8% and 35.2% for the nine-months ended March 27, 2004 and March 29, 2003, respectively.

Table of Contents

Franchise profit contribution increased 12.1% to \$10.3 million for the nine months ended March 27, 2004 from \$9.1 million in the same period last year. The increase in franchise profit contribution is due to the increase in royalty and franchise fees partially offset by a slight increase in franchise expenses.

Interest Expense. Interest expense, net decreased to \$391,000 for the nine-months ended March 27, 2004 from \$3.9 million in the same period last year. This decrease in interest expense is due to the repurchase of outstanding senior notes during the first six months of Fiscal 2003. The repurchase of these notes was completed using working capital and borrowings under our asset-based revolving credit agreement.

Income Taxes. An income tax expense of \$8.0 million, or 40.5% of pre-tax income, and \$7.7 million, or 40.0% of pre-tax income, was recorded in the nine-months ended March 27, 2004 and March 29, 2003, respectively. The change in tax rate from 40.0% to 40.5% is due to an increase in the overall state tax rate.

Net Income. As a result of the above factors, net income increased to \$11.8 million, or \$0.60 per diluted share in the nine-months ended March 27, 2004, as compared to net income of \$11.5 million, or \$0.58 per diluted share in the same period last year. Weighted average diluted shares outstanding decreased to 19.6 million in the nine-months ended March 27, 2004 from 19.8 million in the same period last year. This decrease is mainly due to a slight decrease in average stock price for the nine months ended March 27, 2004.

Liquidity and Capital Resources

Our cash requirements are primarily for working capital, the opening of new stores, the improvement and expansion of existing facilities and the improvement of information systems. Historically, these cash requirements have been met through cash flow from operations and borrowings under our credit facilities. At March 27, 2004, working capital was \$29.9 million compared to \$11.3 million in the same period last year.

Our current priorities for the use of cash are primarily for investments in high-return capital projects, in particular investments in technology to improve merchandising and distribution, reduce costs, improve efficiencies and assist each store to better serve its customers. Key initiatives include:

- implementing centralized warehousing and distribution facilities;

- executing our store information systems roll-out;

- revitalizing our brand and retail environment;

- evaluating our current and future store locations;

- improving customer service at the stores; and

- enhancing franchise growth.

Our management currently believes that the cash generated by operations, together with the borrowing availability under the Loan Agreement, will be sufficient to meet our working capital needs for the next twelve months, including investments made and expenses incurred in connection with systems development, logistic initiatives and store improvements. We are currently free of debt, which permits us to consider a wide variety of corporate initiatives intended to improve shareholder value, although there is no assurance that any specific initiative will be pursued or consummated.

Table of Contents**Key Indicators of Liquidity and Capital Resources**

The following table sets forth key indicators of our liquidity and capital resources (in thousands):

| | Quarter Ended | | Nine Months Ended | |
|--|-------------------|-------------------|-------------------|-------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| Balance Sheet Data: | | | | |
| Cash and cash equivalents | \$ 15,773 | \$ 3,036 | \$ 15,773 | \$ 3,036 |
| Working capital | 29,946 | 11,322 | 29,946 | 11,322 |
| Total assets | 169,420 | 176,767 | 169,420 | 176,767 |
| Borrowings | | 18,637 | | 18,637 |
| Stockholders equity | 93,101 | 77,319 | 93,101 | 77,319 |
| Other Information: | | | | |
| Depreciation and amortization | \$ 4,614 | \$ 3,959 | \$ 12,306 | \$ 11,092 |
| Cash flows (used in) provided by: | | | | |
| Operating activities | \$ 4,160 | \$ (4,973) | \$ 34,807 | \$ 11,329 |
| Investing activities | (5,109) | (1,480) | (8,638) | (16,637) |
| Financing activities | (3,828) | 6,215 | (13,768) | 4,877 |
| Total cash (used in) provided by | \$ (4,777) | \$ (238) | \$ 12,401 | \$ (431) |

Operating Activities. For the nine months ended March 27, 2004, cash provided by operating activities was \$34.8 million, compared to \$11.3 million for the same period last year. The increase in cash provided by operating activities was primarily attributable to a decrease in inventory. The decrease in average inventory level per store of 22.0% from the same period last year, due to management's inventory reduction initiatives, enabled us to focus on product assortment, merchandise presentation and identify and discontinue slower moving items. The increase was also a result of higher net income and lower accounts payable and other current liabilities.

Investing Activities. Cash used in investing activities for the nine months ended March 27, 2004 was \$8.6 million compared to \$16.6 million in the same period in the last fiscal year. The decrease in cash used in investing activities was primarily attributable to the opening of eight Company-owned stores this year as compared with 31 new store openings and the acquisition of two stores from a franchisee during the same period last year.

Financing Activities. Cash used in financing activities was \$13.8 million for the nine months ended March 27, 2004 compared with cash provided by financing activities of \$4.9 million for the same period last year. Cash generated from operating activities during Fiscal 2004 was used to pay down our revolving credit facility. We also received proceeds of \$1.5 million from the exercise of stock options and warrants in Fiscal 2004 and \$1.5 million in Fiscal 2003.

Loan Agreement. At March 27, 2004, we had no balance outstanding under the Loan Agreement. Under the terms

of the Loan Agreement, we may from time to time borrow amounts based on a percentage of our eligible inventory and credit card receivables, up to a maximum of \$65 million at any time outstanding, subject to certain borrowing conditions and customary sub-limits, reserves and other limitations. Interest on each advance is charged, at our option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50%, and is currently at 1.25%, per annum or (ii) at the prime rate less the applicable margin, which was initially set at and is currently 0.25% per annum, (totaling 3.75% at March 27, 2004). The term of the Loan Agreement is through April 30, 2006, and borrowings are secured by a lien on substantially all of our assets. At March 27, 2004 and May 3, 2004, we had no borrowings outstanding under the Loan Agreement. Based on a percentage of current eligible inventory and credit card receivables, we had \$23.4 million available to be borrowed under the Loan Agreement at May 3, 2004.

Stock Repurchase. In September 2001, the Board of Directors authorized us to repurchase up to \$15 million of our outstanding common stock. Stock repurchases are made at the discretion of management. There was no stock repurchase activity during the first nine months of Fiscal 2004. During the first nine months of Fiscal 2003, we purchased approximately 463,000 shares for an aggregate amount of \$4.1 million. As of March 27, 2004, we had purchased 747,012 shares for an aggregate amount of \$5.9 million or 39.6% of the total amount to be purchased.

Table of Contents

Warrants. There were no warrant exercises in the first nine months of Fiscal 2004. In the first nine months of Fiscal 2003, 688,000 warrants to purchase our common stock were exercised. This included an exercise of 458,667 warrants for which proceeds of \$490,774 were received and a cashless exercise of the remaining 229,333 warrants for which the warrant holders received 213,792 shares of common stock. The remaining 15,541 shares were surrendered in connection with this exercise. These 15,541 shares of our common stock had a market value of \$245,386 at the time of surrender.

EBITDA (Earnings before interest, taxes, depreciation and amortization)

| | Quarter Ended | | Nine Months Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| EBITDA (a) | \$ (4,654) | \$ 1,154 | \$ 32,493 | \$ 34,186 |
| Most directly comparable GAAP measures: | | | | |
| Net (loss) income | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |
| Cash flows provided by (used in) operating activities | 4,160 | (4,973) | 34,807 | 11,329 |

(a) Our definition of EBITDA is earnings before interest, taxes, depreciation and amortization. We believe EBITDA provides additional information for determining our ability to meet future debt service requirements. EBITDA should not be construed as a substitute for net income or net cash provided by operating activities (all as determined in accordance with generally accepted accounting principles) for the purpose of analyzing our operating performance, financial position and cash flows as EBITDA is not defined by generally accepted accounting principles. We have presented EBITDA, however, because it is commonly used by certain investors and analysts to analyze and compare companies on the basis of operating performance and to determine a company's ability to service and/or incur debt. Our computation of EBITDA may not be comparable to similar titled measures of other companies.

Because we consider EBITDA useful as an operating measure, a reconciliation of EBITDA to net (loss) income follows for the periods indicated:

| | Quarter Ended | | Nine Months Ended | |
|--------------------------------------|---------------------------|---------------------------|---------------------------|---------------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| EBITDA(a) | \$ (4,654) | \$ 1,154 | \$ 32,493 | \$ 34,186 |
| Depreciation and amortization | (4,614) | (3,959) | (12,306) | (11,092) |
| Interest expense, net | (79) | (208) | (391) | (3,917) |
| Benefit (provision) for income taxes | 3,786 | 1,205 | (8,017) | (7,671) |
| Net (loss) income | \$ (5,561) | \$ (1,808) | \$ 11,779 | \$ 11,506 |

Table of Contents

Because we also consider EBITDA useful as a liquidity measure, we present the following reconciliation of EBITDA to our net cash provided by (used in) operating activities:

| | Quarter Ended | | Nine Months Ended | |
|---|-------------------|-------------------|-------------------|-------------------|
| | March 27, 2004 | March 29, 2003 | March 27, 2004 | March 29, 2003 |
| EBITDA(a) | \$ (4,654) | \$ 1,154 | \$ 32,493 | \$ 34,186 |
| Interest expense, net | (79) | (208) | (391) | (3,917) |
| Benefit (provision) for income taxes | 3,786 | 1,205 | (8,017) | (7,671) |
| Non-cash interest | 40 | 30 | 120 | 1,584 |
| Deferred rent | (86) | 31 | (326) | 558 |
| Stock-based compensation | 270 | 47 | 418 | 799 |
| Provision for doubtful accounts | 58 | 142 | (82) | (460) |
| Other | 3 | | 13 | |
| Changes in assets and liabilities: | | | | |
| Accounts payable, accrued expenses and other current liabilities | 1 | (6,134) | 3,438 | 8,253 |
| Merchandise inventory | (823) | (6,967) | 4,804 | (19,882) |
| Other long-term liabilities | | 45 | (119) | (95) |
| Other current assets and other assets | 5,644 | 5,682 | 2,456 | (2,026) |
| Net cash provided by (used in) operating activities | \$ 4,160 | \$ (4,973) | \$ 34,807 | \$ 11,329 |

We use EBITDA to determine our executive compensation which bases incentive compensation payments on our EBITDA performance measured against budget. EBITDA is also widely used by us and others in our industry to evaluate and price potential acquisitions.

EBITDA has limitations as an analytical tool, and you should not consider it in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

EBITDA does not reflect our current or future requirements for capital expenditures or contractual commitments;

EBITDA does not reflect changes in, or cash requirements for, our working capital needs;

EBITDA does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments, on our debts;

Although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and EBITDA does not reflect any cash requirements for such replacements; and

Other companies in our industry may calculate EBITDA differently than we do, limiting its usefulness as a

comparative measure.

Because of these limitations, EBITDA should not be considered as a measure of discretionary cash available to us to invest in the growth of our business. We compensate for these limitations by relying primarily on our GAAP results and using EBITDA only supplementally. See the Statements of Cash Flows included in our financial statements.

Restatement of the Consolidated Statement of Cash Flows:

As discussed in Note 12 to the condensed consolidated financial statements, we restated our condensed consolidated statement of cash flows for nine month period ended March 29, 2003 to reflect the cash flows related to our cash overdraft as a financing activity rather than an operating activity.

The consolidated statements of cash flows for the six months ended December 27, 2003 and December 28, 2002, three months ended September 27, 2003 and September 28, 2002 and for the fiscal years ended June 28, 2003, June 29, 2002 and June 30, 2001 will also be restated to correct the classification of these cash flows. We anticipate amending our Form 10-Q for the periods ended December 27, 2003 and September 27, 2003 and our Form 10-K for the year ended June 28, 2003 in the near future. A summary of the effect of the restatement on cash flows provided by (used in) operating and our financing activities in these statements of cash flows is as follows (in thousands):

| | <u>As Previously Reported</u> | <u>As Restated</u> |
|--|-----------------------------------|------------------------|
| Six months ended December 27, 2003 | | |
| Operating Activities: | \$ 30,647 | \$ 34,724 |
| Financing Activities: | (9,940) | (14,017) |
| Six months ended December 28, 2002 | | |
| Operating Activities: | 19,915 | 16,346 |
| Financing Activities: | (4,907) | (1,338) |
| Three months ended September 27, 2003 | | |
| Operating Activities: | (1,783) | 795 |
| Financing Activities: | 4,462 | 1,884 |
| Three months ended September 28, 2002 | | |
| Operating Activities: | (4,814) | (5,120) |
| Financing Activities: | 16,973 | 17,279 |
| Year ended June 28, 2003 | | |
| Operating Activities: | 24,129 | 23,088 |
| Financing Activities: | (1,990) | (949) |
| Year ended June 29, 2002 | | |
| Operating Activities: | 34,127 | 31,042 |
| Financing Activities: | (20,494) | (17,409) |
| Year ended June 30, 2001 | | |
| Operating Activities: | 29,655 | 33,876 |
| Financing Activities: | (8,099) | (12,320) |

Table of Contents**Contractual Obligations and Commercial Commitments**

To facilitate an understanding of our contractual obligations and commercial commitments, the following data is provided as of March 27, 2004:

| | Payments Due By Period (in thousands) | | | | |
|-------------------------------|--|-----------------|------------------|------------------|--------------------------|
| | Total | 1 Year | 2-3 Years | 4-5 Years | After 5 years |
| Contractual obligations: | | | | | |
| Operating leases | \$233,745 | \$46,159 | \$84,868 | \$64,365 | \$38,353 |
| Other contractual obligations | 1,000 | 1,000 | — | — | — |
| Total contractual obligations | <u>\$234,745</u> | <u>\$47,159</u> | <u>\$84,868</u> | <u>\$64,365</u> | <u>\$38,353</u> |

Our rent expense under operating leases provides for step rent provisions, escalation clauses, capital improvement funding and other lease concessions as applicable in each lease. The minimum lease payments are recognized on a straight-line basis over the term of each individual underlying lease.

Other contractual obligations include a commitment for selected equipment and services associated with our logistics initiative.

We enter into arrangements to purchase merchandise up to eight months in advance of expected delivery. These purchase orders do not contain any significant termination payments or other penalties if cancelled.

As of March 27, 2004 and May 5, 2004, we had a contingent liability related to severance payments for 14 and 15 employees, respectively. The total contingent liability ranges from zero to approximately \$2.1 million. As of March 27, 2004 and May 5, 2004, we had a standby letter of credit of \$3.7 million pursuant to the Loan Agreement.

Off-Balance Sheet Arrangements

We have not created, and are not party to, any special-purpose or off-balance sheet entities for the purpose of raising capital, incurring debt or operating our business.

Recent Accounting Pronouncements

FASB Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of APB No. 50 (FIN 46), was issued in January 2003, as amended by FIN 46-R. FIN 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. The provisions of FIN 46 must be applied no later than the first reporting period ending after March 15, 2004. The Company does not currently participate in any variable interest entities.

Forward-Looking Statements

This Quarterly Report on Form 10-Q (including the information incorporated herein by reference) contains forward-looking statements within the meaning of The Private Securities Litigation Reform Act of 1995. The statements are made a number of times throughout the document and may be identified by forward-looking terminology as estimate, project, expect, believe, may, will, intend or similar statements or variations of such. Such forward-looking statements are based on many assumptions that are subject to certain risks and uncertainties, and include among others, the following: levels of sales, store traffic, acceptance of product offerings, competitive pressures from other party supplies retailers and other retailers, availability of qualified personnel, availability of suitable future store locations, schedules of store expansion plans and other factors beyond our control. As a result of the foregoing risks and uncertainties, actual results and performance may differ materially from those projected or suggested herein. Additional information concerning certain risks and uncertainties that could cause our actual results to differ materially from those projected or suggested may be identified from time to time in our Securities and Exchange Commission filings and our public announcements.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

In the normal course of doing business, we are exposed to interest rate change and market risk. We generally borrow only during certain times of the year as our borrowing patterns are cyclical. Therefore, a sudden increase in interest rates (which under the Loan

Table of Contents

Agreement is dependent on, at our option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was set initially at 1.50% per annum, and is currently at 1.25% per annum, or (ii) at the prime rate less the applicable margin, which was set initially at and is 0.25% per annum (totaling 3.75% at March 27, 2004)) may, during peak borrowing, have a negative impact on short-term results. We believe that our interest rate risk is minimal as a hypothetical 1.0% increase or decrease in interest rates in the associated debt's variable rate would not materially affect our results of operations or cash flows.

Item 4. Controls and Procedures

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's (the SEC) rules and forms and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

As required by SEC Rule 13a-15(b), we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective at the reasonable assurance level.

In connection with the SEC's review of our 10-K for the year ended June 28, 2003, we concluded that there is a reportable condition (as defined under standards established by the American Institute of Certified Public Accountants) relating to our internal controls over our financial reporting relating to the classification of a financing activity on the cash flow statement. This reportable condition has been thoroughly discussed among management, the audit committee and our independent auditors. Previously, the change in the cash overdraft from year to year was classified in net cash provided by operating activities rather than net cash provided by financing activities. For purposes of this Quarterly Report on Form 10-Q, we have restated our condensed consolidated statements of cash flows for the nine months ended March 29, 2003 to reflect the cash flow related to our cash overdraft in the condensed consolidated statements of cash flows as a financing activity rather than an operating activity. We have enhanced our internal control over financial reporting, including expanding our review of policies and procedures, which we expect will rectify this condition.

Other than as described above, there has been no change in our internal control over financial reporting during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

The information set forth in Note 7 in the Condensed Consolidated Financial Statements included herein is hereby incorporated by reference.

Item 2. *Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities*

None

Item 3. *Defaults Upon Senior Securities*

None

Item 4. *Submission of Matters to a Vote of Security Holders*

None

Item 5. *Other Information*

None

Item 6. *Exhibits and Reports on Form 8-K*

(a) The exhibits required to be filed as part of this report on Form 10-Q are listed in the attached Exhibit Index.

(b) Reports on Form 8-K:

We furnished a Current Report on Form 8-K dated January 8, 2004 under Item 12 in reference to a press release dated January 8, 2004 reporting certain information regarding our sales results for the second quarter ended December 27, 2003.

We furnished a Current Report on Form 8-K dated January 12, 2004 under Items 5 and 7 in reference to a press release dated January 12, 2004 reporting that Nancy Pedot was named Chief Executive Officer on a permanent basis and that she would remain on the Board of Directors, and that Rick Griner assumed the newly created position of Chief Operating Officer and has resigned from the Board.

We furnished a Current Report on Form 8-K dated February 6, 2004 under Item 12 in reference to a press release dated February 6, 2004 reporting certain information regarding our operating results for the second quarter ended December 27, 2003.

Table of Contents

EXHIBIT INDEX

Exhibit No.

| | | |
|---|------|--|
| * | 3.1 | Amended and Restated Certificate of Incorporation of the Company. |
| | 3.2 | Bylaws of the Company as amended, incorporated by reference from the Company's Quarterly Report on Form 10-Q as filed with the Commission on November 12, 2003 (the November 2003 10-Q). |
| | 4.1 | Specimen stock certificate evidencing the Common Stock, incorporated by reference from the Company's Registration Statement as amended on Form S-1 Number 333-00350 as filed with the Commission on January 18, 1996 (the S-1). |
| | 4.2 | Form of Amended and Restated Warrant, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on January 19, 2000 (the January 2000 8-K). |
| | 4.3 | Form of Securities Purchase Agreement, dated as of August 16, 1999, by and between the Company and each of the Investors, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on August 25, 1999 (the August 1999 8-K). |
| | 4.4 | First Amendment to Securities Purchase Agreement, dated as of January 14, 2000, by and between the Company and each of the Investors, incorporated by reference from the January 2000 8-K. |
| | 4.5 | Third Amendment to Securities Purchase Agreement, dated as of April 1, 2001, by and among the Company and each of the Investors, incorporated by reference from the Company's Quarterly Report on Form 10-Q as filed with the Commission on May 15, 2001 (the May 2001 10-Q). |
| | 10.1 | Form of Unit Franchise Agreement entered into by the Company and franchisees, incorporated by reference from the S-1. |
| | 10.2 | Option Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Amendment No. 1 to Schedule 13D as filed by Jack Futterman with the Commission on June 17, 1999 (Futterman's 13D). |
| | 10.3 | Stock Pledge Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman, incorporated by reference from Futterman's 13D. |
| | 10.4 | Amended and Restated Investor Rights Agreement, dated as of August 18, 2003, by and among the Company and the Investors, incorporated by reference from the Company's Annual Report on Form 10-K as filed with the Commission on September 26, 2003 (the September 2003 10-K). |
| | 10.5 | Description of oral consulting agreement between the Company and Ralph Dillon, incorporated by reference from the Company's Quarterly Report on Form 10-Q as filed with the Commission on February 13, 2001. |
| | 10.6 | General Release and Severance Agreement of James Shea, dated |

Table of Contents

Exhibit No.

as of May 28, 2003, by and between the Company and James Shea, incorporated by reference from the September 2003 10-K.

- 10.7 Separation Agreement of Andrew Bailen, dated as of July 14, 2003, by and between the Company and Andrew Bailen, incorporated by reference from the September 2003 10-K.
- 10.8 Separation Agreement of Thomas Larson, dated as of August 26, 2002, by and between the Company and Thomas Larson, incorporated by reference from the September 2003 10-K.
- 10.9 Employment Agreement of Steven Skiba, dated as of November 29, 2002, by and between the Company and Steven Skiba, incorporated by reference from the September 2003 10-K.
- 10.10 Employment Agreement of Linda Siluk, dated as of November 7, 2003, by and between the Company and Linda M. Siluk, incorporated by reference from the November 2003 10-Q.
- 10.11 Employment Agreement of Warren Jeffrey, dated as of November 7, 2003, by and between the Company and Warren Jeffery, incorporated by reference from the November 2003 10-Q.
- 10.12 Employment Agreement of Richard H. Griner dated as of January 12, 2004, by and between the Company and Richard H. Griner, incorporated by reference from the February 2004 10-Q.
- 10.13 Management Stock Purchase Plan of the Company, incorporated by reference from the Registration of Form S-8 as filed with the Commission on July 23, 2001.
- 10.14 Employee Stock Purchase Plan of the Company, incorporated by reference from the Company's Definitive Proxy Statement for the 2001 Annual Meeting of Stockholders, included within Form 14-A as filed with the Commission on October 18, 2001.
- 10.15 Amended and Restated 1994 Stock Option Plan, incorporated by reference from the Registration of Form S-8 as filed with the Commission on January 9, 1997.
- 10.16 1999 Stock Incentive Plan (Amended and Restated as of October 17, 2003), incorporated by reference from the Company's Definitive Proxy Statement for the 2003 Annual Meeting of Stockholders included within Form 14-A as filed with the Commission on October 20, 2003.
- 10.17 Loan and Security Agreement (the "Loan Agreement"), dated January 9, 2003, by and between the Company and Wells Fargo Retail Finance, LLC ("WFRF"), as the arranger, collateral agent and administrative agent, and Fleet Retail Finance, Inc., as the documentation agent, incorporated by reference from the Company's Current Report on Form 8-K as filed with the Commission on January 10, 2003.
- 10.18 Stock Pledge Agreement, dated January 9, 2003, by and among the Company, Party City Michigan, Inc. ("PCMI") and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K.
- 10.19

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Trademark Security Agreement, dated January 9, 2003, by and between the Company and WFRF,
as the arranger, collateral agent and administrative agent for the lender group under the
29

Table of Contents

Exhibit No.

| | |
|--------|---|
| | Loan Agreement, incorporated by reference from the September 2003 10-K. |
| 10.20 | Copyright Security Agreement, dated January 9, 2003, by and between the Company and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K. |
| 10.21 | Guaranty and Security Agreement, dated January 9, 2003, by and between PCMI and WFRF, as the arranger, collateral agent and administrative agent for the lender group under the Loan Agreement, incorporated by reference from the September 2003 10-K. |
| 21.1 | Subsidiaries, incorporated by reference from the September 2003 10-K. |
| * 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| * 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| * 32.1 | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| * 32.2 | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

* Included herein

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PARTY CITY CORPORATION

By /s/ NANCY PEDOT

(Nancy Pedot)
Chief Executive Officer
(principal executive officer)

By /s/ LINDA M. SILUK

(Linda M. Siluk)
Chief Financial Officer
(principal financial and
accounting officer)

Date: May 17, 2004

Table of Contents

INDEPENDENT ACCOUNTANTS REPORT

To the Board of Directors and Stockholders of
Party City Corporation
Rockaway, New Jersey

We have reviewed the accompanying condensed consolidated balance sheets of Party City Corporation and Subsidiary as of March 27, 2004 and March 29, 2003, and the related condensed consolidated statements of operations for the quarter and nine month periods ended March 27, 2004 and March 29, 2003 and of cash flows for the nine month periods ended March 27, 2004 and March 29, 2003. These interim financial statements are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to such condensed consolidated financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Party City Corporation and Subsidiary as of June 28, 2003, and the related consolidated statements of income, shareholders' equity, and cash flows for the year then ended (not presented herein); and in our report dated August 21, 2003, we expressed an unqualified opinion (and included an explanatory paragraph relating to the adoption of new accounting standard) on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of June 28, 2003 is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

As discussed in Note 12, the condensed consolidated statement of cash flows for the nine month period ended March 29, 2003 has been restated.

DELOITTE & TOUCHE LLP

New York, New York
May 17, 2004