PARTY CITY CORP
Form 10-Q
May 14, 2002

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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 30, 2002 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 07866Rockaway, 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 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, 2002, there were outstanding 13,333,518 shares of Common Stock, $.01 par value.

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PARTY CITY CORPORATION AND SUBSIDIARY

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PART 1. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

PARTY CITY CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED BALANCE SHEETS
(dollars in thousands)

	March 30, 2002	March 31, 2001	June 30, 2001
	(Unaudited)	(Unaudited)	
ASSETS			
Current assets:			
Cash and cash equivalents	$7,455	$12,006	$9,842
Merchandise inventory	60,952	54,569	48,034
Deferred income taxes	5,031	5,305	3,798
Other current assets	13,349	14,211	12,156
Total current assets	86,787	86,091	73,830
Property and equipment, net	46,024	42,437	46,351
Goodwill, net	14,206	13,950	13,647
Other assets	5,901	3,824	7,514
Total assets	$152,918	$146,302	$141,342

LIABILITIES AND STOCKHOLDERS EQUITY

Current liabilities:			
Accounts payable	$40,846	$40,004	$27,905
Accrued expenses and other current liabilities	23,191	18,726	26,274
Senior Notes, current portion	7,655	14,655	11,366
Total current liabilities	71,692	73,385	65,545
Deferred rent and other long-term liabilities	9,725	8,531	8,701
Senior Notes	8,759	15,488	16,006
Commitments and contingencies			
Stockholders equity:			
Common stock, $.01 par value, authorized 25,000,000 shares; issued 13,289,767, 12,722,661 and 12,723,455 shares, respectively	133	127	127
Additional paid-in capital	38,654	37,972	38,236
Retained earnings	25,784	10,799	12,727
Treasury stock, at cost (284,000 shares)	(1,829)		
Total stockholders equity	62,742	48,898	51,090

Total liabilities and stockholders equity	$152,918	$146,302	$141,342

See accompanying notes to condensed consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(Unaudited)

	Quarter ended		**Nine months ended**	
	March 30, 2002	**March 31, 2001**	**March 30, 2002**	**March 31, 2001**
Revenues:				
Net sales	$86,252	$74,298	$309,026	$289,186
Royalty fees	3,652	2,911	13,031	11,184
Franchise fees	200		543	609
Total revenues	90,104	77,209	322,600	300,979
Expenses:				
Cost of goods sold and occupancy costs	60,816	53,364	202,411	192,254
Company-owned stores operating and selling expense	20,031	18,329	69,724	67,442
Franchise expense	1,612	1,436	4,826	3,849
General and administrative expense	6,707	8,150	19,409	18,361
Total expenses	89,166	81,279	296,370	281,906

Income (loss) before interest and income taxes	938	(4,070)	26,230	19,073
Interest expense, net	1,099	1,752	4,508	6,038
Income (loss) before income taxes	(161)	(5,822)	21,722	13,035
Provision for income taxes (benefit)	(65)	(2,295)	8,665	5,002
Net income (loss)	($96)	($3,527)	$13,057	$8,033
Basic earnings (loss) per share	($0.01)	($0.28)	$1.01	$0.63

Weighted average shares outstanding basic	12,982	12,723	12,909	12,722
Diluted earnings (loss) per share	($0.01)	($0.28)	$0.69	$0.46
Weighted average shares outstanding diluted	12,982	12,723	18,972	17,646

See accompanying notes to condensed consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Nine months ended	
	March 30, 2002	March 31, 2001
	(Unaudited)	
Cash flow from operating activities:		
Net income	$13,057	$8,033
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	8,944	7,769
Impairment of assets		2,103
Deferred taxes	462	3,196
Non-cash interest	1,128	1,275
Deferred rent and other long-term liabilities	1,024	651
Equity-based compensation	257	
Provision for doubtful accounts	59	160
Changes in assets and liabilities:		
Merchandise inventory	(12,620)	(13,141)
Other current assets and other assets	(1,242)	2,400
Accounts payable and other current liabilities	9,858	10,057
Net cash provided by operating activities	20,927	22,503
Cash flow from investment activities:		
Purchases of property and equipment		

	(8,493)	(9,989)
Proceeds from sale of stores to franchisees		1,157
Stores and non-compete agreement acquired from franchisees	(1,504)	(516)
Net cash used in investment activities	(9,997)	(9,348)
Cash flow from financing activities:		
Payments of Senior Notes	(11,655)	(5,103)
Purchases of treasury stock	(1,829)	
Proceeds from exercise of stock options	167	4
Net cash used in financing activities	(13,317)	(5,099)
Net increase (decrease) in cash and cash equivalents	(2,387)	8,056
Cash and cash equivalents, beginning of period	9,842	3,950
Cash and cash equivalents, end of period	$7,455	$12,006

Supplemental disclosure of cash flow information:		
Income taxes paid	$9,785	$5,217
Interest paid	4,098	5,019

See accompanying notes to condensed consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION

The condensed consolidated financial statements, except for the June 30, 2001 consolidated balance sheet, 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 the Company as of March 30, 2002 and March 31, 2001 and the results of operations for the quarters and nine months ended March 30, 2002 and March 31, 2001 and cash flows for the nine months ended March 30, 2002 and March 31, 2001. Because of the seasonality of the party goods industry, operating results of the Company on a quarterly 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 fiscal year ended June 30, 2001, 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 27, 2001. All significant intercompany accounts and transactions have been eliminated. The June 30, 2001 consolidated balance sheet amounts are derived from the Company s audited consolidated financial statements.

2. RECENT ACCOUNTING STANDARDS

In October of 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement supersedes SFAS No. 121 Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed of, but retains the fundamental provisions of SFAS No. 121 for recognition and measurement of the impairment of long-lived assets to be held and used and measurement of long-lived assets to be disposed of by sale. However, SFAS No. 144 applies the fair value method for testing of impairment, which differs from SFAS No. 121. SFAS No. 144 also supersedes the accounting and reporting provisions of APB Opinion No. 30 as it pertains to disposal of a business segment but retains the requirement of that opinion to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of or is classified as held for sale. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, thereby applying to the Company upon the commencement of its fiscal 2003 fiscal year. The Company is evaluating the impact of the adoption of this standard and has not yet determined the effect of adoption on its financial position and results of operations.

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. 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 30, 2002	March 31, 2001	March 30, 2002	March 31, 2001
	(Unaudited)		(Unaudited)	
Net income (loss)	$(96)	$(3,527)	$13,057	$8,033
Earnings (loss) per share basic	$(0.01)	$(0.28)	$1.01	$0.63
Earnings (loss) per share diluted	$(0.01)	$(0.28)	$0.69	$0.46
Average common shares outstanding	12,982	12,723	12,909	12,722
Dilutive effect of warrants	(a)	(b)	5,461	4,694
Dilutive effect of stock options(c)	(a)	(b)	532	230
Restricted shares			70	
Average common and common equivalent shares outstanding	12,982	12,723	18,972	17,646
Average common stock price used for treasury method	$10.53	$3.35	$8.21	$3.39

(a) Options to purchase 1,009,888 shares of common stock at prices ranging from $2.00 to $32.50 per share and warrants to purchase 6,280,000 shares of common stock at $1.07 per share were outstanding at March 30, 2002 but were not included in the computation of dilutive loss per share for the quarter ended March 30, 2002 because to do so would have been anti-dilutive.

(b) Options to purchase 1,075,481 shares of common stock at prices ranging from $2.25 to $32.50 per share and warrants to purchase 6,880,000 shares of common stock at $1.07 per share were outstanding at March 31, 2001 but were not included in the computation of dilutive loss per share for the quarter ended March 31, 2001 because to do so would have been anti-dilutive.

(c) Options to purchase 578,541 shares of common stock at prices ranging from $7.00 to $32.50 and options to purchase

913,638 shares of common stock at prices ranging from $2.85 to $32.50 were outstanding but were not included in the computation of dilutive earnings per share for the nine months ended March 30, 2002 and March 31, 2001, respectively, because to do so would have been anti-dilutive for the periods presented.

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4. STOCK REPURCHASE

On September 19, 2001, the Board of Directors authorized the Company to repurchase up to $15 million of the Company s outstanding common stock. The stock repurchases are made at the discretion of management. As of March 30, 2002, the Company had repurchased 284,000 shares for an aggregate amount of $1.8 million, or 12.2% of the total amount authorized to be repurchased. No stock repurchases were made during the quarter ended, or subsequent to, March 30, 2002.

5. DEBT MATURITIES

The amounts of Senior Notes (as defined below) outstanding are as follows (in thousands):

Note	Description	March 30, 2002	March 31, 2001	June 30, 2001
Series A	12.5%(i) Secured Notes due 2003	$2,552	$5,104	$5,104
Series B	13.0%(i) Secured Notes due 2003	5,103	5,103	5,103
Series C	13.0%(i) Secured Notes due 2002		5,103	5,103
Series D	14.0%(i) Secured Notes due 2004	10,207	10,207	10,207
Series E	14.0% Senior Secured Notes due 2002		7,000	4,000
		17,862	32,517	29,517
Unamortized debt discount		(1,448)	(2,374)	(2,145)
Less: Current portion, net of debt discount		(7,655)	(14,655)	(11,366)
		$8,759	$15,488	$16,006

(i) Interest rate was increased by 450 basis points for all amounts outstanding on and after January 13, 1999.

6. LITIGATION

The Company was named as a defendant in twelve class action complaints. The Company s former Chief Executive Officer and the former Chief Financial Officer and Executive Vice President of Operations were also named as defendants. All of the complaints were filed in the United States District Court for the District of New Jersey. The complaints were filed as class actions on behalf of persons who purchased or acquired Party City common stock during various time periods between February 26, 1998 and March 18, 1999 (the Class Period). In October 1999, plaintiffs filed an amended class action complaint and, in February 2000, plaintiffs filed a second amended complaint.

The second amended complaint alleged, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified damages. The plaintiffs alleged that defendants issued a series of false and misleading statements and failed to disclose material facts concerning, among other things, the Company s financial condition, adequacy of internal controls and compliance with certain loan covenants during the Class Period. The plaintiffs further alleged that because of the issuance of a series of false and misleading statements and/or the failure to disclose material facts, the price of Party City s common stock was artificially inflated.

In early 2000, defendants moved to dismiss the second amended complaint on the ground that it failed to state a cause of action. On May 29, 2001, the District Court issued an Opinion and Order dismissing the Complaint against all defendants with prejudice. On June 27, 2001, plaintiffs filed a Notice of Appeal to the United States Court of Appeals for the Third Circuit. Prior to the argument of the appeal, the parties reached an agreement in principle to settle the action. The parties have requested that the Court of Appeals remand the case to the District Court to supervise the implementation of the settlement. The proposed amount to be paid by the Company under the settlement is not material and is subject to various conditions. These include the completion of the negotiation of a definitive settlement agreement and the approval of the terms of the settlement agreement by the District Court after notice to the members of the class who have the right to object. There can be no assurance that all these conditions will be satisfied.

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A lawsuit was filed on September 25, 2001 against the Company 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 as exempt from California overtime wage and hour laws. The lawsuit seeks relief in the form of disgorgement of overtime wages allegedly owed by the Company to the Class but not paid. The plaintiffs also seek punitive damages and statutory penalties. The Company denies the allegations and is vigorously defending against the claim.

In addition to the foregoing, the Company is from time to time involved in routine litigation incidental to the conduct of its business. The Company is aware of no other material existing or threatened litigation to which it is or may be a party.

7. SEGMENT INFORMATION

The following table contains key financial information of the Company s business segments (in thousands):

	Quarter ended		Nine months ended	
	March 30, 2002	March 31, 2001	March 30, 2002	March 31, 2001
	(Unaudited)		(Unaudited)	
RETAIL				
Net revenue	$86,252	$74,298	$309,026	$289,186
Operating earnings	5,405	2,605	36,891	29,490
Identifiable assets	131,779	130,543	131,779	130,543
Depreciation/amortization	1,829	2,262	5,439	6,098
Capital expenditures	1,663	2,090	4,024	4,413
FRANCHISING				
Net revenue	$3,852	$2,911	$13,574	$11,793
Operating earnings	2,240	1,475	8,748	7,944
Identifiable assets	2,923	2,215	2,923	2,215
Depreciation/amortization				
Capital expenditures				
CORPORATE/OTHER				
Net revenue	$	$	$	$
Operating loss	(6,707)	(8,150)	(19,409)	(18,361)
Identifiable assets	18,216	13,544	18,216	13,544
Depreciation/amortization	1,244	335	3,505	1,671
Capital expenditures	1,897	3,510	4,584	5,863
CONSOLIDATED TOTALS				
Net revenue	$90,104	$77,209	$322,600	$300,979

Operating income (loss)	938	(4,070)	26,230	19,073
Interest expense, net	1,099	1,752	4,508	6,038
Income (loss) before income taxes (benefit)	(161)	(5,822)	21,722	13,035
Provision for income taxes (benefit)	(65)	(2,295)	8,665	5,002
Net income (loss)	($96)	($3,527)	$13,057	$8,033
Identifiable assets	$152,918	$146,302	$152,918	$146,302
Depreciation/amortization	3,073	2,597	8,944	7,769
Capital expenditures	3,560	5,600	8,608	10,276

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PARTY CITY CORPORATION AND SUBSIDIARY

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. GOODWILL AND OTHER INTANGIBLE ASSETS

On July 1, 2001, the Company adopted SFAS No. 142, Goodwill and Other Intangible Assets. As a result, the Company no longer amortizes goodwill. Instead the Company periodically evaluates goodwill for recoverability. The Company also evaluates goodwill whenever events and changes in circumstance suggest that the carrying amount may not be recoverable from its estimated future cash flows. Upon adoption, the Company established reporting units based on its current reporting structure. The Company then assigned all goodwill to the reporting units, as well as other assets and liabilities, to the extent that they relate to the reporting unit. The Company completed the first step of the transitional goodwill impairment test and has determined that no potential impairment exists. As a result, no transitional impairment loss was recorded in fiscal 2002 in connection with the adoption of SFAS No. 142.

The following pro forma financial information is presented as if the statement were adopted at the beginning of the quarter ended September 30, 2000 (in thousands, except per share amounts):

	Quarter ended		Nine months ended	
	March 30, 2002	March 31, 2001	March 30, 2002	March 31, 2001
	(Unaudited)		(Unaudited)	
Reported net income (loss)	$(96)	$(3,527)	$13,057	$8,033
Add back:				
Goodwill amortization, net of taxes		181		547
Pro forma net income (loss)	$(96)	$(3,346)	$13,057	$8,580
Earnings (loss) per share reported basic	$(0.01)	$(0.28)	$1.01	$0.63
Goodwill amortization		0.01		0.04

Pro forma earnings (loss) per share basic	$(0.01)	$(0.27)	$1.01	$0.67
Earnings (loss) per share reported diluted	$(0.01)	$(0.28)	$0.69	$0.46
Goodwill amortization		0.01		0.03
Pro forma net earnings (loss) per share diluted	$(0.01)	$(0.27)	$0.69	$0.49

The changes in the carrying amount of goodwill and other intangibles for the nine months ended March 30, 2002, by operating segment, are as follows (in thousands):

Retail:

Balance as of June 30, 2001	$13,647
Goodwill acquired during the period	559
Other intangibles	550
Balance as of March 30, 2002	$14,756

Other intangibles, included in Other assets, consisted of amounts paid to a franchisee in connection with a seven-year agreement not to compete. This intangible asset is being amortized over a seven-year period.

Estimated amortization expense for other intangibles is approximately $21,000 and $27,000 for the quarter and nine months ended March 30, 2002, respectively.

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9. SUBSEQUENT EVENTS

On April 25, 2002, the Company announced that it had completed the acquisition of thirteen stores in the Seattle, Washington market from Paper Warehouse, Inc. The Company plans to convert these locations to the Party City format. Management currently plans to open these stores in its first fiscal quarter ending September 28, 2002.

On May 7, 2002, the Company assumed the lease of a franchisee for a store in Sacramento, California under the default terms of the franchisee's lease agreement. The Company plans to reopen the store in June 2002.

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

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles 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 estimates. Such differences could be material to the consolidated financial statements.

Management believes 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, management has found the application of accounting policies to be appropriate, and actual results generally do not differ materially from those determined using necessary estimates.

The Company s accounting policies are more fully described in Note 1 to the consolidated financial statements set forth in the Company s Annual Report on Form 10-K, filed with the Securities and Exchange Commission on September 27, 2001. Management has identified certain material accounting policies that are more fully described below.

Merchandise inventory - Merchandise inventory is carried at the lower of cost or market on a first-in, first-out basis. Inventory is written down for estimated obsolescence or unmarketable inventory equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

Long-lived assets. In the evaluation of the fair value and future benefits of long-lived assets, management performs an analysis of the anticipated undiscounted future net cash flows of the related long-lived assets. If the carrying value of the related asset exceeds the undiscounted cash flows, the carrying value is reduced to its fair value, which is generally calculated using discounted cash flows. 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.

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Results of Operations

SELECTED FINANCIAL DATA
(in thousands, except per share and store data)

	Quarter ended		Nine months ended	
	March 30, 2002	March 31, 2001	March 30, 2002	March 31, 2001
	(Unaudited)		(Unaudited)	
Statement of Operations Data				
Total revenue	$90,104	$77,209	$322,600	$300,979
Company-owned stores:				
Net sales	$86,252	$74,298	$309,026	$289,186
Cost of goods sold and occupancy costs	60,816	53,364	202,411	192,254
Gross profit	25,436	20,934	106,615	96,932
Store operating and selling expense	20,031	18,329	69,724	67,442

Company-owned stores profit contribution	5,405	2,605	36,891	29,490
Franchise stores:				
Royalty fees	3,652	2,911	13,031	11,184
Franchise fees	200		543	609
Total franchise revenues	3,852	2,911	13,574	11,793
Total franchise expense	1,612	1,436	4,826	3,849
Franchise profit contribution	2,240	1,475	8,748	7,944
General and administrative expense:				
Impairment provision		2,113		2,113
Other general and administrative expenses	6,707	6,037	19,409	16,248
	6,707	8,150	19,409	18,361

Income (loss) before interest and income	938	(4,070)	26,230	19,073
Interest expense, net	1,099	1,752	4,508	6,038
Income (loss) before income taxes (benefit)	(161)	(5,822)	21,722	13,035
Provision for income taxes (benefit)	(65)	(2,295)	8,665	5,002
Net income (loss)	($96)	($3,527)	$13,057	$8,033
Basic earnings (loss) per share	($0.01)	($0.28)	$1.01	$0.63
Diluted earnings (loss) per share	($0.01)	($0.28)	$0.69	$0.46
Weighted average shares outstanding basic	12,982	12,723	12,909	12,722
Weighted average shares outstanding diluted	12,982	12,723	18,972	17,646
EBITDA (a)	4,011	640	35,174	28,955

Depreciation and amortization	3,073	2,597	8,944	7,769

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	Quarter ended		Nine months ended	
	March 30, 2002	March 31, 2001	March 30, 2002	March 31, 2001
	(Unaudited)		(Unaudited)	
Store Data:				
Company-owned:				
Stores open at beginning of period	198	195	193	197
Stores opened	2		6	
Stores closed		(2)		(2)
Stores acquired from franchisees			1	1
Stores sold to franchisees				(3)
Stores open at end of period	200	193	200	193
Average Company-owned stores open in period	199	193	195	194
Franchise:				
Stores open at beginning of period	272	259	261	211
Stores opened	5	2	19	48
Stores closed	(33)(c)		(35)(c)	
Stores sold to Company			(1)	(1)
Stores acquired from Company				3

Stores open at end of period
244 261 244 261

Average franchise stores open in period
267 260 270 236
Total stores chainwide
444 454 444 454

Chainwide sales
$185,644 $164,830 $684,153 $623,402
Same store sales increase:

Company-owned stores
13.5% 12.9% 5.8% 10.5%
Franchise stores
9.7% 10.0% 4.3% 4.3%
Average sales per Company-owned store
$433.4 $384.9 $1,584.7 $1,486.9
Balance Sheet Data:

Working capital
$15,095 $12,706 $15,095 $12,706
Total assets
152,918 146,302 152,918 146,302
Bank borrowings and other debt (b)
16,414 30,154 16,414 30,154
Capital lease obligation
122 540 122 540
Stockholders equity
62,742 48,898 62,742 48,898

(a) The Company s definition of EBITDA is earnings before interest, taxes, depreciation, amortization and impairment provision.
(b) The bank borrowings and other

debt at March 30, 2002 and March 31, 2001 is net of an unamortized debt discount of $1.4 million and $2.4 million, respectively.

(c) Includes 28 stores closed as a result of Canadian franchise bankruptcy.

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Quarter Ended March 30, 2002 Compared to Quarter Ended March 31, 2001

Retail. Net sales from Company-owned stores increased 16.1% to $86.3 million for the third quarter of fiscal 2002 from $74.3 million for the third quarter of the last fiscal year. Benefitting from the earlier Easter holiday, total chain-wide sales (which include aggregate sales for the collective group of Company-owned and franchise stores) increased 12.6% to $185.6 million from $164.8 million in the comparable period last year. Same store sales increased 13.5% in the third quarter of fiscal 2002. Gross profit reflects the cost of goods sold and store occupancy costs including rent, common area maintenance, real estate taxes, repair and maintenance, depreciation and utilities. Gross profit for the third quarter of fiscal 2002 increased 21.5% to $25.4 million from $20.9 million for the third quarter of the last fiscal year. The increase was primarily due to increased sales volume and improved leverage on occupancy costs. Gross margin was 29.5% for the third quarter of fiscal 2002 compared with 28.2% for the third quarter of the last fiscal year.

Store operating and selling expenses increased 9.3% to $20.0 million for the third quarter of fiscal 2002 from $18.3 million in the third quarter of the last fiscal year. The increase in store operating expenses is primarily attributable to the increase in sales. Store operating and selling expenses were 23.2% and 24.7% of sales for the third quarter of fiscal 2002 and fiscal 2001, respectively. The decrease as a percentage of sales is primarily due to increased store labor productivity. Company-owned stores recorded a contribution of $5.4 million for the third quarter of fiscal 2002, compared to $2.6 million for the third quarter of the last fiscal year. The improvement over the prior year is primarily the result of improved gross margin as well as improved operating efficiencies. The Company opened two new stores during the fiscal quarter ended March 30, 2002. No new stores were opened during the quarter ended March 31, 2001. Pre-opening expenses for these stores and other stores planned to be opened later in the fiscal year were $241,000. All costs of pre-opening are expensed when incurred.

Franchising. Franchise revenue is composed of the initial franchise fees that are recorded as revenue when the store opens, and ongoing royalty fees, generally 4.0% of the store s net sales. Five franchise stores were opened and franchise fees of $200,000 were recognized in the third quarter of fiscal 2002. No franchise stores were opened and no franchise fees were recognized in the third quarter of the prior fiscal year. Royalty fees increased 25.5% to $3.7 million in the third quarter of fiscal 2002 from $2.9 million in the third quarter of the last fiscal year which is primarily due to an increase in the average number of stores and a same store sales increase of 9.7% for the franchise stores in the third quarter of fiscal 2002.

Expenses directly related to franchise revenue increased 12.3% to $1.6 million for the third quarter of fiscal 2002 from $1.4 million for the third quarter of the last fiscal year. As a percentage of franchise revenue, franchise expenses were 41.9% and 49.3% for the third quarter of fiscal 2002 and fiscal 2001, respectively, due to increased revenue on relatively fixed operating costs.

General and Administrative Expenses. General and administrative expenses decreased 17.7% to $6.7 million in the third quarter of fiscal 2002 from $8.2 million in the third quarter of the last fiscal year. This decrease is primarily due to an impairment provision of $2.1 million which was recorded in the third quarter of the prior fiscal year related to replacement of store registers. This was offset in part by an increase of $519,000 in depreciation related to new systems placed in service. The balance of the increase is primarily due to increases in legal and tax consulting fees and equity based compensation. General and administrative expenses were 7.8% and 11.0% of sales for the third quarter of fiscal 2002 and fiscal 2001. Exclusive of the impairment provision, general and administrative expenses were 8.1% in the prior fiscal year.

Interest Expense. Interest expense decreased 37.3% to $1.1 million for the third quarter of fiscal 2002 from $1.8 million in the third quarter of the last fiscal year. The decreased expense is primarily attributable to lower outstanding principal balances outstanding due to payments made over the last twelve months on the Company s 12.5% Secured Notes due 2003, 13.0% Secured Notes due 2003, 13.0% Secured Notes due 2002, 14.0% Secured Notes due 2004 and 14.0% Senior Secured Notes due 2002 (collectively, the Senior Notes).

Income Taxes. The Company s effective income tax rate was 40.0% in the third quarter of fiscal 2002 compared to 39.4% in the third quarter of the last fiscal year. The tax rate increased as a result of the increase in the federal statutory rate.

Net Income. As a result of the above factors, net loss for the third quarter of fiscal 2002 was $96,000, or $0.01 loss per basic and diluted share, as compared to net loss of $3.5 million, or $0.28 loss per basic share and diluted share in the third quarter of the last fiscal year.

Nine Months Ended March 30, 2002 Compared to Nine Months Ended March 31, 2001

Retail. Net sales from Company-owned stores increased 6.9% to $309.0 million for the nine months ended March 30, 2002 from $289.2 million for the nine months ended March 31, 2001. Same store sales increased 5.8% in the nine months ended March 30, 2002. Gross profit reflects the cost of goods sold and store occupancy costs including rent, common area maintenance, real estate taxes, repair and maintenance, depreciation and utilities. Gross profit for the nine months ended March 30, 2002 increased 10.0% to $106.6 million from $96.9 million for the nine months ended March 31, 2001. The increase was primarily due to increased sales volume and leverage on fixed occupancy costs. Gross margin was 34.5% for the nine months ended March 30, 2002 compared with 33.5% for the nine months ended March 31, 2001.

Store operating and selling expenses increased 3.4% to $69.7 million for the nine months ended March 30, 2002 from $67.4 million in the nine months ended March 31, 2001. The increase in store operating expenses is attributable to the increase in sales. Store operating and selling expenses were 22.6% and 23.3% of sales for the nine-month period ended March 30, 2002 and March 31, 2001, respectively. The decrease as a percentage of sales is primarily due to improvements in efficiency in the management of store labor hours and savings in advertising and supply expenses. Company-owned stores recorded a contribution of $36.9 million for the nine months ended March 30, 2002 compared to $29.5 million for the nine months ended March 31, 2001. The improvement over the prior year is primarily the result of improved gross margin as well as improved operating efficiencies. The Company opened six new stores during the nine months ended March 30, 2002. No new stores were opened in the nine months ended March 31, 2001. Pre-opening expenses for these stores and stores planned to be opened later in the fiscal year were $456,000. All costs of pre-opening are expensed when incurred.

Franchising. Franchise revenue is composed of the initial franchise fees that are recorded as revenue when the store opens, and ongoing royalty fees, generally 4.0% of the store s net sales. Franchise fees, recognized on 19 store openings, were $543,000 for the nine months ended March 30, 2002, compared to $609,000 for the nine months ended March 31, 2001 relating to 48 store openings. Royalty fees increased 16.5% to $13.0 million in the nine months ended March 30, 2002 from $11.2 million in the nine months ended March 31, 2001 which is primarily due to an increase in the average number of stores and a same store sales increase of 4.3% for the franchise stores in the nine month period ended March 30, 2002.

Expenses directly related to franchise revenue increased 25.4% to $4.8 million for the nine months ended March 30, 2002 from $3.8 million for the nine months ended March 31, 2001. As a percentage of franchise revenue, franchise expenses were 35.6% and 32.6% for the nine months ended March 30, 2002 and March 31, 2001, respectively. This increase is primarily due to the recording of a provision for bad debt related to the Company s Canadian franchisee.

General and Administrative Expenses. General and administrative expenses increased 5.7% to $19.4 million in the nine months ended March 30, 2002 from $18.4 million in the nine months ended March 31, 2001. This increase is attributable, in part, to an increase of $1.4 million in depreciation related to new systems placed in service. The balance of the increase is primarily due to increases in legal and tax consulting fees and equity based compensation. General and administrative expenses were 6.3% of sales for the nine months ended March 30, 2002 and March 31, 2001, respectively, reflecting investments in management and systems. Excluding an impairment provision of $2.1 million which was recorded in the third quarter of the prior fiscal year related to replacement of store registers, general and administrative expenses were 5.6% of sales for the nine months ended March 31, 2001.

Interest Expense. Interest expense decreased 25.3% to $4.5 million for the nine months ended March 30, 2002 from $6.0 million in the nine months ended March 31, 2001. The decreased expense is primarily attributable to lower average borrowings outstanding under the Loan Agreement, dated January 14, 2000, as amended (the Loan Agreement) with Congress Financial Corporation and reduced outstanding principal balances on Senior Notes due to payments made over the last twelve months.

Income Taxes. The effective income tax rate was 40.0% in the nine months ended March 30, 2002 compared to 38.4% in the nine months ended March 31, 2001. The tax rate increased as a result of the increase in the federal statutory rate.

Net Income. As a result of the above factors, net income for the nine months ended March 30, 2002 was $13.1 million, or $1.01 per basic share and $0.69 per diluted share, as compared to net income of 8.0 million, or $0.63 per basic share and $0.46 per diluted share for the nine months ended March 31, 2001.

Liquidity and Capital Resources

The Company s 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 the Loan Agreement. At March 30, 2002, working capital was $15.1 million.

For the nine-month period ended March 30, 2002, cash provided by operating activities was $20.9 million, compared to $22.5 million for the same period of the last fiscal year. The decrease in cash provided by operating activities was primarily attributable to a decrease in non-cash impairment charges compared to the preceding period.

Cash used in investment activities for the nine-month period ended March 30, 2002 was $10.0 million compared to $9.3 million in the same period in the last fiscal year. The increase in cash used in investing activities was primarily attributable to the continued investment in new systems, new stores and payments made for an acquisition. Six Company-owned stores were opened in the period.

Cash used in financing activities was $13.3 million for the nine-month period ended March 30, 2002. This relates to payments of $11.7 million on Senior Notes and purchases of treasury stock of $1.8 million.

At March 30, 2002, the Company had a nominal balance outstanding under the Loan Agreement due to accrued fees. Under the terms of the Loan Agreement, the Company may from time to time borrow amounts, based on a percentage of its eligible inventory, up to a maximum of $40 million at any time outstanding. Advances bear interest, at the Company s option, (i) at the adjusted Eurodollar rate plus the applicable margin, which was 2.25% per annum at March 30, 2002 or (ii) at the rate of 3/4% per annum above the prime rate, totaling 5.5% at March 30, 2002. The term of the Loan Agreement is three years, and is secured by a lien on substantially all of the assets of the Company. At May 3, 2002, the Company had no balance outstanding and $33.2 million was available to be borrowed under the Loan Agreement.

Company management currently believes that the cash generated by operations, together with the borrowing availability under the Loan Agreement, will be sufficient to meet the Company s working capital needs for the next twelve months, including planned new store openings.

Accounting and Reporting Changes

In October of 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. This statement supersedes SFAS No. 121 but retains the fundamental provisions of SFAS No. 121 for recognition and measurement of the impairment of long-lived assets to be held and used and measurement of long-lived assets to be disposed of by sale. However, SFAS No. 144 applies the fair value method for testing of impairment, which differs from SFAS No. 121. SFAS No. 144 also supersedes the accounting and reporting provisions of APB Opinion No. 30 as it pertains to disposal of a business segment but retains the requirement of that opinion to report discontinued operations separately from continuing operations and extends that reporting to a component of an entity that either has been disposed of or is classified as held for sale. SFAS No. 144 is effective for fiscal years beginning after December 15, 2001, thereby applying to the Company upon the commencement of its fiscal 2003 fiscal year. The Company is evaluating the impact of the adoption of this standard and has not yet determined the effect of adoption on its financial position and results of operations.

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Forward-Looking Statements

This 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 terms. Such forward-looking statements involve 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, availability of qualified personnel, availability of suitable future store locations, schedules of store expansion plans and other factors. As a result of the foregoing risks and uncertainties, actual results and performance may differ materially from that projected or suggested herein. Additional information concerning certain risks and uncertainties that could cause actual results to differ materially from that projected or suggested may be identified from time to time in the Company s Securities and Exchange Commission filings and the Company s public announcements.

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

The Company, in the normal course of doing business, is exposed to interest rate change market risk. As borrowing patterns are cyclical, the Company is not dependent on borrowing throughout the year. Therefore, a sudden increase in interest rates (which under the Loan Agreement is dependent on the prime rate) may, during peak borrowing, have a negative impact on short-term results.

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PART II OTHER INFORMATION

Item 1. ***Legal Proceedings***

The Company was named as a defendant in twelve class action complaints. The Company s former Chief Executive Officer and the former Chief Financial Officer and Executive Vice President of Operations were also named as defendants. All of the complaints were filed in the United States District Court for the District of New Jersey. The complaints were filed as class actions on behalf of persons who purchased or acquired Party City common stock during various time periods between February 26, 1998 and March 18, 1999 (the Class Period). In October 1999, plaintiffs filed an amended class action complaint and, in February 2000, plaintiffs filed a second amended complaint.

The second amended complaint alleged, among other things, violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder, and sought unspecified damages. The plaintiffs alleged that defendants issued a series of false and misleading statements and failed to disclose material facts concerning, among other things, the Company s financial condition, adequacy of internal controls and compliance with certain loan covenants during the Class Period. The plaintiffs further alleged that because of the issuance of a series of false and misleading statements and/or the failure to disclose material facts, the price of Party City's common stock was artificially inflated.

In early 2000, defendants moved to dismiss the second amended complaint on the ground that it failed to state a cause of action. On May 29, 2001, the District Court issued an Opinion and Order dismissing the Complaint against all defendants with prejudice. On June 27, 2001, plaintiffs filed a Notice of Appeal to the United States Court of Appeals for the Third Circuit. Prior to the argument of the appeal, the parties reached an agreement in principle to settle the action. The parties have requested that the Court of Appeals remand the case to the District Court to supervise the implementation of the settlement. The proposed amount to be paid by the Company under the settlement is not material and is subject to various conditions. These include the completion of the negotiation of a definitive settlement agreement and the approval of the terms of the settlement agreement by the District Court after notice to the members of the class who have the right to object. There can be no assurance that all these conditions will be satisfied.

A lawsuit was filed on September 25, 2001 against the Company 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 as exempt from California overtime wage and hour laws. The lawsuit seeks relief in the form of disgorgement of overtime wages allegedly owed by the Company to the Class but not paid. The plaintiffs also seek punitive damages and statutory penalties. The Company denies the allegations and is vigorously defending against the claim.

In addition to the foregoing, the Company is from time to time involved in routine litigation incidental to the conduct of its business. The Company is aware of no other material existing or threatened litigation to which it is or may be a party.

Item 2. **Changes in Securities and Use of Proceeds**

None

Item 3. ***Defaults upon Senior Securities***

None

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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

None

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EXHIBIT INDEX

Exhibit No.	
3.1(1)	Certificate of Incorporation of the Company.
3.2(4)	Bylaws of the Company, as amended.
4.1(1)	Specimen stock certificate evidencing the Common Stock.
4.2(5)	Form of Amended and Restated Warrant.
4.3(2)	Form of A Note.
4.4(2)	Form of B Note.
4.5(2)	Form of C Note.
4.6(2)	Form of D Note.
4.7(5)	Form of E Note.
4.8(2)	Form of Securities Purchase Agreement, dated as of August 16, 1999, by and between the Company and each of the Investors.
4.9(5)	First Amendment to Securities Purchase Agreement, dated as of January 14, 2000, by and between the Company and each of the Investors.
4.10(7)	Second Amendment

to Securities Purchase Agreement, dated as of April 1, 2001, by and among the Company and each of the Investors.	10.1(1)
Form of Unit Franchise Agreement entered into by the Company and franchisees.	10.2(6)
Amended and Restated 1999 Stock Incentive Plan of the Company.	10.3(3)
Option Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman.	10.4(3)
Stock Pledge Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futterman.	10.5(3)
Employment Agreement, dated as of June 8, 1999, between the Company and Jack Futterman.	10.6(2)
Investor Rights Agreement, dated as of August 16, 1999, by and among the Company, the Investors	

and Jack Futterman. 10.7(2)

Standstill and Forbearance Agreement, dated as of August 16, 1999, by and among the Company, PNC Bank, National Association, as Agent, and the Banks. 10.8(2)

Vendor Forbearance and Standstill Agreement, dated as of August 16, 1999, by and among the Company and the Trade Vendors.

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Exhibit No.

10.9(7) First Amendment to Investor Rights Agreement, dated as of October 11, 2000, by and among the Company, the Investors and Jack Futterman. 10.10(7) Second Amendment to Investor Rights Agreement, dated as of November 20, 2000, by and among the Company, the Investors and Jack Futterman. 10.11(5) Loan and Security Agreement, dated January 14, 2000, by and between the Company and Congress Financial Corporation. 10.12(6) Description of oral consulting agreement between the Company and Ralph Dillon. 10.13(6) Employment Agreement of James Shea, dated as of December 10, 1999, by and between the Company and James Shea. 10.14(6) Employment Agreement of

Andrew Bailen, dated as of August 7, 2000, by and between the Company and Andrew Bailen. 10.15(6)

Employment Agreement of Thomas Larson, dated as of June 18, 1999, by and between the Company and Thomas Larson. 10.16(8)

Management Stock Purchase Plan of the Company 21.1

Subsidiaries. The wholly owned subsidiary of the Company is Party City Michigan, Inc. incorporated on October 23, 1997, in the State of Delaware. This subsidiary does business under the name Party City Michigan, Inc.

Notes

(1) Incorporated by reference to the Company s Registration Statement as amended on Form S-1 Number 333-00350 as filed with the Commission on January 18, 1996.

(2) Incorporated by reference to the Company s Current Report on Form 8-K as filed with the Commission on August 25, 1999.

(3) Incorporated by reference to Amendment No. 1 to Schedule 13D as filed by Jack Futterman with the Commission on June 17, 1999.

(4) Incorporated by reference to the Company s Current Report on Form 8-K as filed with the Commission on June 8, 2000.

(5) Incorporated by reference to the Company s Current Report on Form 8-K as filed with the Commission on January 19, 2000.

(6) Incorporated by reference to the Company s Quarterly Report on Form 10-Q as filed with the Commission on February 13, 2001.

(7) Incorporated by reference to the Company s Quarterly Report on Form 10-Q as filed with the Commission on May 15, 2001.

(8) Incorporated by reference to the Company s Registration Statement on Form S-8 as filed with the Commission on July 23, 2001.

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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/ JAMES SHEA

(James Shea) *Chief Executive Officer*

By /s/ THOMAS E. LARSON

(Thomas E. Larson) *Chief Financial Officer*

By /s/ LINDA M. SILUK

(Linda M. Siluk) *Chief Accounting Officer*

Date: May 14, 2002

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