PARTY CITY CORP
Form 10-Q
May 15, 2001

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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 MARCH 31, 2001

COMMISSION FILE NUMBER 0-27826

PARTY CITY CORPORATION
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE 22--3033692
(State or other jurisdiction of (I.R.S. Employer
incorporation or organization) 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 /X/ 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 10, 2001, there were outstanding 12,722,521 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

(IN THOUSANDS)

	MARCH 31, 2001	JULY 1, 2000
	(UNAUDITED)	See note
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,006	$ 3,950
Merchandise inventory	54,569	42,030
Deferred income taxes	5,305	5,976
Other current assets	14,211	16,803
Total current assets	86,091	68,759
Property and equipment, net	42,437	41,447
Goodwill, net	13,950	14,844
Other assets	3,824	7,036
Total assets	$146,302	$132,086
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 40,004	$ 30,190

Accrued expenses and other current liabilities	18,715	18,397
Advances under Loan Agreement	11	--
Senior Notes, current portion	14,655	5,103
Total current liabilities	73,385	53,690
Long-term liabilities:		
Deferred rent and other long-term liabilities	8,531	7,988
Senior Notes	15,488	29,547
Commitments and contingencies		
Stockholders' equity:		
Common stock	127	127
Additional paid-in capital	37,972	37,968
Retained earnings	10,799	2,766
Total stockholders' equity	48,898	40,861
Total liabilities and stockholders' equity	$146,302	$132,086

Note: The balance sheet at July 1, 2000 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements.

See accompanying notes to consolidated financial statements.

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PARTY CITY CORPORATION AND SUBSIDIARY

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE DATA)

	QUARTER ENDED		NIN
	MARCH 31, 2001	APRIL 1, 2000	MARCH 2001
	(Unaudited)		(
Revenues:			
Net sales	$ 74,298	$ 66,400	$289,1
Royalty fees	2,911	2,472	11,1
Franchise fees	--	--	6
Total revenues	77,209	68,872	300,9
Expenses:			
Cost of goods sold and occupancy costs	53,364	49,669	192,2
Company-owned stores operating and selling expense	18,329	18,381	67,4
Franchise expense	1,436	987	3,8
General and administrative expense	8,150	6,302	18,3

Total expenses	81,279	75,339	281,9
Income (loss) before interest and income taxes	(4,070)	(6,467)	19,0
Interest expense, net	1,752	2,157	6,0
Income (loss) before income taxes (benefit)	(5,822)	(8,624)	13,0
Provision for income taxes (benefit)	(2,295)	--	5,0
Net income (loss)	($ 3,527)	($ 8,624)	$ 8,0
Basic income (loss) per share	($ 0.28)	($ 0.68)	$ 0.
Weighted average shares outstanding - basic	12,723	12,722	12,7
Diluted income (loss) per share	($ 0.28)	($ 0.68)	$ 0.
Weighted average shares outstanding - diluted	12,723	12,722	17,6

See accompanying notes to condensed consolidated financial statements.

PARTY CITY CORPORATION AND SUBSIDIARY
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)

	NINE MONTHS ENDED	
	MARCH 31, 2001	APRIL 1, 2000
	(Unaudited)	
Cash flow from operating activities:		
Net income	$ 8,033	$ 355
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,769	7,669
Impairment and loss on disposal of assets	2,103	1,462
Non-cash interest	1,275	888
Deferred rent	876	796
Provision for doubtful accounts	160	853
Deferred tax asset	3,196	(915)
Changes in assets and liabilities:		
Merchandise inventory	(13,141)	(9,281)
Other assets	2,400	15,112
Accounts payable	9,815	(19,921)
Accrued expenses and other liabilities	6	4,448
Net cash provided by operating activities	22,492	1,466
Cash flow from investment activities:		
Purchases of property and equipment	(9,989)	(2,530)
Proceeds from sale of stores to franchisees	1,157	9,877

Stores acquired from franchisees	(516)	--
Net cash provided by (used in) investment activities	(9,348)	7,347
Cash flow used in financing activities:		
Net proceeds from Loan Agreement	11	6,916
Proceeds from issuance of stock in exchange for services and stock options	4	790
Proceeds from (payments on) Senior Notes	(5,103)	37,281
Payment of Senior Notes issuance costs	--	(2,225)
Net payments on Credit Agreement	--	(58,550)
Net cash used in financing activities	(5,088)	(15,788)
Net increase (decrease) in cash and cash equivalents	8,056	(6,975)
Cash and cash equivalents, beginning of period	3,950	11,470
Cash and cash equivalents, end of period	$ 12,006	$ 4,495
Supplemental disclosure of cash flow information:		
Income taxes paid	$ 5,217	$ 97
Interest paid	5,019	1,630

See accompanying notes to condensed consolidated financial statements.

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 the Company as of March 31, 2001, and the results of operations and cash flows for the quarters and nine months ended March 31, 2001 and April 1, 2000. 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 year.

These condensed consolidated financial statements should be read in conjunction with the Company's audited consolidated financial statements for the year ended July 1, 2000, included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission. All significant intercompany accounts and transactions have been eliminated. The July 1, 2000 consolidated balance sheet amounts have been derived from the Company's audited consolidated financial statements.

2. LITIGATION

Securities Litigation

The Company has been 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 have also been named as defendants. The complaints have all been 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 1998 and March 19, 1999. In February 2000, plaintiffs filed a second amended class action complaint.

The second amended complaint alleges, among other things, violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks unspecified damages. The plaintiffs allege 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. The plaintiffs further allege that because of the issuance of a series of false and misleading statements and/or failure to disclose material facts, the price of Party City common stock was artificially inflated.

Defendants have moved to dismiss the second amended complaint on the ground that it fails to state a cause of action. The Court has not yet issued a decision with respect to the motion to dismiss. Because this case is in its early stages, no opinion can be expressed as to its likely outcome.

Although the Company's management is unable to express a view on the likely outcome of this litigation because it is in its early stages, it could have a material adverse effect on the Company's business and results of operations.

Other

On April 23, 1999, plaintiff Emil Asch, Inc. ("Emil Asch") filed a complaint in the United States District Court for the Eastern District of New York against the Company and co-defendants Amscan, Inc., Hallmark, Inc., and Rubie's Costume. The complaint alleges five claims which pertain to price discrimination under the Robinson-Patman Act, unfair competition, tortious interference with contractual relations, and false and deceptive advertising. Plaintiff seeks damages of $2 million, as well as treble and punitive damages for certain counts.

On February 3, 2000, Emil Asch amended its complaint by adding Ron's: The Party Store, Inc., as an additional plaintiff to the suit. The amended complaint asserts the same causes of action against the same defendants and seeks the same damages that were sought in the original complaint. The Company has settled the case and on May 10, 2001, the Court approved a stipulation entered into by the plaintiffs and the Company dismissing the case.

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.

3. SEGMENT INFORMATION

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

	QUARTER ENDED		NINE MONTHS END	
	MARCH 31, 2001	APRIL 1, 2000	MARCH 31, 2001	AP
	(UNAUDITED)		(UNAUDITED	
RETAIL				
Net revenue	$ 74,298	$ 66,400	$ 289,186	$
Operating earnings (loss)	2,605	(1,650)	29,490	
Identifiable assets	130,543	124,303	130,543	
Depreciation/amortization	2,262	2,057	6,098	
Capital expenditures	2,090	241	4,413	
FRANCHISING				
Net revenue	$ 2,911	$ 2,472	$ 11,793	$
Operating earnings	1,475	1,485	7,944	
Identifiable assets	2,215	1,748	2,215	
Depreciation/amortization	--	--	--	
Capital expenditures	--	--	--	
CORPORATE/OTHER				
Net revenue	$ --	$ --	$ --	$
Operating loss	(8,150)	(6,302)	(18,361)	
Identifiable assets	13,544	9,228	13,544	
Depreciation/amortization	335	283	1,671	
Capital expenditures	3,510	497	5,863	
CONSOLIDATED TOTALS				
Net revenue	$ 77,209	$ 68,872	$ 300,979	$
Operating earnings (loss)	(4,070)	(6,467)	19,073	
Interest expense, net	1,752	2,157	6,038	
Income (loss) before income taxes (benefit)	(5,822)	(8,624)	13,035	
Provision for income taxes (benefit)	(2,295)	--	5,002	
Net income (loss)	($ 3,527)	($ 8,624)	$ 8,033	$
Identifiable assets	$ 146,302	$ 135,279	$ 146,302	$
Depreciation/amortization	2,597	2,340	7,769	
Capital expenditures	5,600	738	10,276	

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4. EARNINGS PER SHARE

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

	QUARTER ENDED		NINE MONTHS ENDED	
	MARCH 31, 2001	APRIL 1, 2000	MARCH 31, 2001	APRIL 2000
	(UNAUDITED)		(UNAUDITED)	

Net income (loss)	($ 3,527)	($ 8,624)	$ 8,033	$ 35
Average common shares outstanding	12,723	12,722	12,722	12,57
Income (loss) per share - basic	($ 0.28)	($ 0.68)	$ 0.63	$ 0.0
Dilutive effect of stock options	(a)	(b)	230	1
Dilutive effect of warrants	(a)	(b)	4,694	1,19
Average common and common equivalents outstanding	12,723	12,722	17,646	13,78
Income (loss) per share - diluted	($ 0.28)	($ 0.68)	$ 0.46	$ 0.0

(a) Options to purchase 901,833 common shares at prices ranging from $3.40 to $32.50 per share and warrants to purchase 6,880,000 common shares at $1.07 per share were outstanding at March 31, 2001, but were not included in the computation of diluted earnings per share because to do so would have been antidilutive.

(b) Options to purchase 1,025,529 commons shares at prices ranging from $2.25 to $32.50 per share and warrants to purchase 6,880,000 common shares at $1.07 per share were outstanding at April 1, 2000, but were not included in the computation of diluted earnings per share because to do so would have been antidilutive.

5. FRANCHISE ADDITIONS

In October 2000, the Company signed an agreement with The Party Supermarket, Inc. ("Party Supermarket") whereby Party Supermarket would become a franchisee of the Company. Under that agreement, Party Supermarket purchased three stores in Florida from the Company for approximately $1.2 million. A gain of $131,000 was recorded in the second quarter on this sale. The Company estimates that Party Supermarket will operate 21 stores as franchise stores after their conversion to the Party City concept. This conversion is expected to be completed in the second quarter of Fiscal 2002.

6. SENIOR NOTES

At March 31, 2001, the aggregate maturities of Senior Notes are as follows:

Fiscal year ending June/July:

2001	$ --
2002	14,655
2003	7,655
2004	10,207
	32,517
Less: Unamortized debt discount	(2,374)
	$ 30,143

The Company has a Loan and Security Agreement (the "Loan Agreement") with Congress Financial Corporation ("Congress"), as lender. 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 2.75% per annum (subject to possible reduction to an interest rate as low as 2.25% from and after June 30, 2001, based on the Company's pre-tax income and excess availability) or (ii) at the rate of 3/4% per annum above the prime rate, totaling 9.25% at March 31, 2001. 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 10, 2001, there was no balance outstanding and $28.7 million was available to be borrowed under the Loan Agreement.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

RESULTS OF OPERATIONS

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

	QUARTER ENDED		
	MARCH 31, 2001	APRIL 1, 2000	MA
	(UNAUDITED)		
STATEMENT OF OPERATIONS DATA			
Total revenue	$ 77,209	$ 68,872	$3
Company-owned stores			
Net sales	$ 74,298	$ 66,400	$2
Cost of goods sold and occupancy costs	53,364	49,669	1
Gross profit	20,934	16,731	
Store operating and selling expense	18,329	18,381	
Company-owned stores profit contribution (loss)	2,605	(1,650)	
Franchise stores:			
Royalty fees	2,911	2,472	
Franchise fees	--	--	
Total franchise revenues	2,911	2,472	
Total franchise expense	1,436	987	
Franchise profit contribution	1,475	1,485	
General and administrative expense:			
Impairment provision (a)	2,113	--	
Special charges (b)	--	811	
Other general and administrative expenses	6,037	5,491	

	8,150	6,302	
Income (loss) before interest and income taxes (benefit)	(4,070)	(6,467)	
Interest expense, net	1,752	2,157	
Income (loss) before income taxes (benefit)	(5,822)	(8,624)	
Provision for income taxes (benefit)	(2,295)	--	
Net income (loss)	($ 3,527)	($ 8,624)	$
Basic earnings (loss) per share	($ 0.28)	($ 0.68)	$
Diluted earnings (loss) per share (c)	($ 0.28)	($ 0.68)	$
Weighted average shares outstanding - Basic	12,723	12,722	
Weighted average shares outstanding - Diluted (c)	12,723	12,722	
EBITDA (d)	640	(3,316)	
Depreciation and amortization	2,597	2,340	

(a) A charge for impairment was provided for the net book value of store register systems replaced in the Company's information systems initiatives.

(b) Special charges in fiscal 2000 relate to consulting services, accounting fees, bank fees, legal fees and other expenses related to the Company's financial restructuring.

(c) Options and warrants were not included in the computation of diluted earnings per share for the quarter ended March 31, 2001 and April 1, 2000 because to do so would be antidilutive.

(d) The Company's definition of EBITDA is earnings before interest, taxes, depreciation, amortization and impairment provision and exclusive of special charges, as defined above.

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	QUARTER ENDED		NI
	MARCH 31, 2001	APRIL 1, 2000	MARC 20
	(Unaudited)		
STORE DATA:			
COMPANY-OWNED:			
Stores open at beginning of period	195	198	
Stores opened	--	1	
Stores closed	(2)	(1)	
Stores acquired from franchisees	--	--	
Stores sold to franchisees	--	--	
Stores open at end of period	193	198	
FRANCHISE:			
Stores open at beginning of period	259	206	
Stores opened	2	3	
Stores closed	--	(1)	
Stores sold to Company	--	--	
Stores acquired from Company	--	--	

Stores open at end of period	261	208	
Total stores chainwide	454	406	
Increase in Company-owned same store sales	12.9%	4.4%	
Increase in franchise same store sales	10.0%	(1.2%)	
Average sales per Company-owned store	$ 384.9	$ 339.5	$ 1,
BALANCE SHEET DATA:			
Working capital	$ 12,706	$ 20,940	$ 1
Total assets	146,302	135,279	14
Bank borrowings and other debt	30,154	41,451	3
Capital lease obligation	540	795	
Stockholders' equity	48,898	40,235	4

Quarter Ended March 31, 2001 Compared to Quarter Ended April 1, 2000

Retail. Net sales from Company-owned stores increased 11.9% to $74.3 million for the quarter ended March 31, 2001 from $66.4 million for the quarter ended April 1, 2000. Same store sales increased 12.9% in the quarter ended March 31, 2001. 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 quarter ended March 31, 2001 increased 25.1% to $20.9 million from $16.7 million for the quarter ended April 1, 2000. The increase was due primarily to increased sales volume and increases in initial margin. Gross margin was 28.2% for the quarter ended March 31, 2001 compared with 25.2% for the quarter ended April 1, 2000 . The increase in gross margin is related primarily to improved buying practices.

Store operating and selling expenses were $18.3 million for the quarter ended March 31, 2001 compared to $18.4 million for the quarter ended April 1, 2000. Store operating and selling expenses were 24.7% and 27.7% of sales for the quarter ended March 31, 2001 and April 1, 2000, respectively. This decrease is due to efficiencies in labor utilization in stores. Company-owned stores recorded a contribution of $2.6 million for the quarter ended March 31, 2001 compared to a negative contribution of $1.7 million for the quarter ended April 1, 2000

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. No franchise fees were recognized during the quarter ended March 31, 2001. Royalty fees increased 17.8% to $2.9 million in the quarter ended March 31, 2001 from $2.5 million in the quarter ended April 1, 2000 primarily due to an

increase in the number of stores and a same store sales increase of 10% for the franchise stores in the quarter ended March 31, 2001.

Expenses directly related to franchise revenue increased 45.5% to $1.4 million for the quarter ended March 31, 2001 from $987,000 for the quarter ended April 1, 2000. As a percentage of franchise revenue, franchise expenses were 49.3% and 39.9% for the quarters ended March 31, 2001 and April 1, 2000, respectively.

Franchise profit contribution was unchanged at $1.5 million for the third quarter compared to $1.5 million for the third quarter of the last fiscal year.

General and Administrative Expenses. Included in general and administrative expenses is a charge of $2.1 million for impairment due to the replacement of store registers in connection with the Company's new point of sale system implementation. Excluding this charge, general and administrative expenses were 8.1% and 9.5% of sales for the quarters ended March 31, 2001 and April 1, 2000, respectively.

Interest Expense. Interest expense decreased 18.8% to $1.8 million for the third quarter from $2.2 million in the third quarter of the last fiscal year. The decreased expense is primarily attributable to lower average borrowings outstanding.

Income Taxes. An income tax benefit of $2.3 million was recorded in the third quarter of fiscal 2001, compared to no income tax benefit in the third quarter of the prior fiscal year. The effective income tax rate was 39.4% in the third quarter. The absence of a tax benefit in the prior fiscal year was primarily due to uncertainties relating to the use of federal and state net operating loss carryovers.

Net Income. As a result of the above factors, net loss for the quarter ended March 31, 2001 was $3.5 million, or $0.28 loss per basic and diluted share, as compared to net loss of $8.6 million, or $0.68 loss per basic and diluted share for the quarter ended April 1, 2000.

NINE MONTHS ENDED MARCH 31, 2001 COMPARED TO NINE MONTHS ENDED APRIL 1, 2000

Retail. Net sales from Company-owned stores increased 9.1% to $289.2 million for the nine months ended March 31, 2001, from $265.0 million for the nine months ended April 1, 2000. This increase is the result of strong same-store sales increases due to better in-stock positions. Same store sales increased 10.5% in the nine-month period ended March 31, 2001. 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-month period ended March 31, 2001 increased 14.2% to $96.9 million from $84.9 million for the nine-month period ended April 1, 2000. The increase in gross profit is primarily due to increases in initial margin and improvements in buying practices. Gross margin was 33.5% for the nine-month period ended March 31, 2001 compared with 32.0% for the nine-month period ended April 1, 2000.

Store operating and selling expenses increased 5.3% to $67.4 million for the nine-month period ended March 31, 2001 from $64.1 million in the nine-month period ended April 1, 2000. The increase in store operating expenses is attributable primarily to increased payroll expenses of $1.7 million and increased supplies expense of $395,000. Store operating and selling expenses were 23.3% and 24.2% of sales for the nine-month periods ended March 31, 2001 and April 1, 2000, respectively. Company-owned stores recorded a profit contribution of $29.5 million for the nine-month period ended March 31, 2001, compared to a contribution of $20.8 million for the comparable period in the previous fiscal year. The increased contribution was primarily the result of improved margin and increased sales.

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% of the store's net sales. Franchise fees, recognized on 48 store openings were $609,000 for the nine-month period ended March 31, 2001 compared to $322,000 for the comparable period in the prior fiscal year, which represents 15 store openings. Royalty fees increased 11.1% to $11.2 million in the nine-month period ended March 31, 2001 from $10.1 million

in the comparable period in the prior fiscal year due primarily to an increase in the number of franchise stores and same-store sales increases of 4.3%.

Expenses directly related to franchise revenue increased 18.8% to $3.8 million for the nine-month period ended March 31, 2001 from $3.2 million for the comparable nine-month period in the prior fiscal year. As a percentage of franchise revenue, franchise expenses were 32.6% and 31.2%, respectively.

Franchise profit contribution increased 11.1% to $7.9 million for the nine-month period ended March 31, 2001 from $7.1 million for the nine-month period ended April 1, 2000. The increase in franchise profit contribution is due to higher revenues from the increased number of franchise stores and same-store sales increases.

General and Administrative. Included in general and administrative expenses is a charge of $2.1 million of impairment due to the replacement of store registers in connection with the Company's new point of sale system implementation. Excluding this charge and special charges of $7.1 million for the nine months ended April 1, 2000, general and administrative expenses were 5.6% and 5.3% of sales for the nine-month periods ended March 31, 2001 and April 1, 2000, respectively.

Interest Expense. Interest expense decreased 9.4% to $6.0 million for the nine-month period ended March 31, 2001 from $6.7 million in the nine-month period ended April 1, 2000. The decreased expense is primarily attributable to lower average borrowings because of improved liquidity.

Income Taxes. Taxes of $5.0 million were recorded in the nine-month period ended March 31, 2001 compared to a benefit of $237,000 in the nine-month period ended April 1, 2000. The effective income tax rate was 38.4% in the nine-month period ended March 31, 2001. The disproportionate tax benefit recorded in the prior fiscal year was primarily due to reduced valuation allowances against deferred tax assets and use of previous federal and state net operating losses.

Net Income. As a result of the above factors, net income for the nine-month period ended March 31, 2001 was $8.0 million, or $0.63 per basic share and $0.46 per diluted share compared to a net income of $355,000, or $0.03 per basic and diluted share in nine-month period ended April 1, 2000.

LIQUIDITY AND CAPITAL RESOURCES

For the nine-month period ended March 31, 2001, cash provided by operating activities increased to $22.5 million, compared to $1.5 million for the nine-month period ended April 1, 2000. The increase in cash provided by operating activities was primarily attributable to a $9.8 million increase in accounts payable, a $13.1 million increase in inventory and net income of $8.0 million.

Cash used in investing activities for the nine-month period of fiscal 2001 was $9.3 million compared to cash provided by investing activities of $7.3 million in the nine-month period in the last fiscal year. The change was primarily attributable to one store acquisition in the first quarter of fiscal year 2001 and increased investment in property and equipment in the nine-month period ended March 31, 2001 compared to the nine-month period ended April 1, 2000. The property and equipment increase relates primarily to new information systems initiatives.

Cash used in financing activities was $5.1 million for the nine-month period ended March 31, 2001 compared to $15.8 million in the nine-month period ended April 1, 2000.

The Company has a Loan and Security Agreement (the "Loan Agreement") with Congress Financial Corporation ("Congress"), as lender. 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 2.75% per annum (subject to possible reduction to an interest rate as low as 2.25% from and after June 30, 2001, based on the Company's pre-tax income and excess availability) or (ii) at the rate of 3/4% per annum above the prime rate, totaling 9.25% at March 31,

2001. 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 10, 2001, there was no balance outstanding and $28.7 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 scheduled maturities of the Senior Notes. A required payment of $5.1 million on the Senior Note was made on January 31, 2001.

Accounting and Reporting Changes

In November 1999, the Securities and Exchange Commission ("SEC") issued Staff Accounting Bulletin No. 101, "Revenue Recognition." This bulletin sets forth the SEC Staff's position regarding the point at which it is appropriate for a Registrant to recognize revenue. The Staff believes that revenue is realizable and earned when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or service has been rendered; the seller's price to the buyer is fixed or determinable; and collectibility is reasonably assured. The Company uses the above criteria to determine whether revenue can be recognized, and therefore believes that the issuance of this bulletin does not have a material impact on its financial statements.

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 such as "estimate", "project", "expect", "believe", "may", "will", "intend" or similar statements or variations of such 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 year 2000 readiness issues relating to the Company's internal systems and those of third parties 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 SEC filings and the Company's public announcements.

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Securities Litigation

The Company has been 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 have also been named as defendants. The complaints have all been 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 1998 and March 19, 1999. In February 2000, plaintiffs filed a second class action amended complaint.

The second amended complaint alleges, among other things, violations of sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks unspecified damages. The plaintiffs allege 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. The plaintiffs further allege that because of

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the issuance of a series of false and misleading statements and/or failure to disclose material facts, the price of Party City common stock was artificially inflated.

Defendants have moved to dismiss the second amended complaint on the ground that it fails to state a cause of action. The Court has not yet issued a decision with respect to the motion to dismiss. Because this case is in its early stages, no opinion can be expressed as to its likely outcome.

Although the Company's management is unable to express a view on the likely outcome of this litigation because it is in the early stages, it could have a material adverse effect on the Company's business and results of operations.

Other

On April 23, 1999, plaintiff Emil Asch, Inc. ("Emil Asch") filed a complaint in the United States District Court for the Eastern District of New York against the Company and co-defendants Amscan, Inc., Hallmark, Inc., and Rubie's Costume. The complaint alleges five claims which pertain to price discrimination under the Robinson-Patman Act, unfair competition, tortious interference with contractual relations, and false and deceptive advertising. Plaintiff seeks damages of $2 million, as well as treble and punitive damages for certain counts.

On February 3, 2000, Emil Asch amended its complaint by adding Ron's: The Party Store, Inc., as an additional plaintiff to the suit. The amended complaint asserts the same causes of action against the same defendants and seeks the same damages that were sought in the original complaint. The Company has settled the case and on May 10, 2001, the court approved a stipulation entered into by the plaintiffs and the Company dismissing the case.

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

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) Report on Form 8-K
None

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 betwe Company and each of the Investors.
4.9(5)	--	First Amendment to Securities Purchase Agreement, dated as of January 14, 2000, between the Company and each of the Investors.
4.10	--	Second Amendment to Securities Purchase Agreement, dated as of April 1, 2001, by 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 Stock Option Plan of the Company.
10.3(3)	--	Option Agreement, dated as of June 8, 1999, between Steven Mandell and Jack Futt
10.4(3)	--	Stock Pledge Agreement, dated as of June 8, 1999, between Steven Mandell and Jac
10.5(3)	--	Employment Agreement, dated as of June 8, 1999, between the Company and Jack Fut
10.6(2)	--	Investor Rights Agreement, dated as of August 16, 1999, by and among the Company Investors and Jack Futterman.
10.7(2)	--	Standstill and Forbearance Agreement, dated as of August 16, 1999, by and among 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 Company and the Trade Vendors.
10.9	--	First Amendment to Investor Rights Agreement, dated as of October 11, 2000, by a Company, the Investors and Jack Futterman.
10.10	--	Second Amendment to Investor Rights Agreement, dated as of November 20, 2000, by the Company, the Investors and Jack Futterman.
10.11(5)	--	Loan and Security Agreement, dated January 14, 2000, by and between the Company 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 betwee and James Shea.
10.14(6)	--	Employment Agreement of Andrew Bailen, dated as of August 7, 2000, by and betwee and Andrew Bailen.
10.15(6)	--	Employment Agreement of Gordon Keil, dated as of April 12, 2000, by and between and Gordon Keil.
10.16(6)	--	Employment Agreement of Thomas Larson, dated as of June 18, 1999, by and between and Thomas Larson.
21.1	--	Subsidiaries. The wholly owned subsidiary of the Company is Party City Michigan incorporated on October 23, 1997, in the State of Delaware. This subsidiary doe 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 333-350 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 with the Commission on June 30, 1999.

(4) Incorporated by reference to the Company's Current Report on Form 8-K as filed with the Commission on February 17, 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.

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, 2001