

Party City Holdco Inc (NYSE: PRTY)

Recommendation:

Long Party City 6.125% Unsecured Notes due 2023 due to a recently announced Transaction Support Agreement converting all senior unsecured notes to senior secured notes and partial equity ownership. Additionally, due to liquidity and availability concerns of the underlying, the **Party City 6.625% Unsecured Notes due 2026**, provide an additional investment option to capitalize on this situation, although at a lower return.

Business Overview:

Party City Holdco Inc is a party goods retailer in North America that operates owned and franchised locations in the US, Canada, and Puerto Rico. Party City also sells internationally in countries like the UK, France, Germany, and Australia, among others. The company has two primary reporting segments: **retail (56% of total sales in 2019) and wholesale (44% of total sales in 2019)**.

- The retail operations sell through Anagram, Amscan, Designware, Costumes USA, and other party suppliers, such as Party City, Halloween City, and PartyCity.com. The company operates 875 stores.
- The wholesale segment sells party goods such as paper and plastic tableware, accessories and novelties, balloons, stationery, and gift items for all occasions. These products are sold by franchise stores, mass merchants, independent card and gift shops, dollar stores, and other retailers and global distributors.
- Party City has acquired over 21 various specialty retail and consumer party businesses to vertically integrate the business. One subsidiary, Anagram, a producer and distributor of foil balloons has an estimated **50-55% global market share of the foil balloon market** according to Party City estimates.
- The company completed a **sale leaseback resulting in \$58M gain and also closed 55 stores in 2019**.
- With over 30,000 SKU's sold in store and over 40,000 SKU's sold online, Party City has a large product assortment. Additionally, a strong portfolio of licenses including brands like Disney and the NBA, allow Party City to market to specialty events and interests.

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- Revenue has stagnated at ~\$2.3B over the last five years briefly peaking at \$2.43B while gross margins have also stagnated at ~15%

Current Situation:

On Friday 5/29/20, Party City announced a Transaction Support Agreement (“TSA”) to reduce debt and increase liquidity for the company. This exchange, **will swap \$850M in notional value of unsecured bonds with senior secured notes**. Additionally, the exchange will allow noteholders and other interested parties to participate in a rights offering of \$100M of senior secured notes. Subsequent to the successful raising of the entire amount in the rights offering an additional \$15M premium will be allotted across the 2025 variable rate notes and the senior secured 15% notes.

Capital Structure:**Party City**

Old Capital Structure

	Outstanding (\$M)	Amount (\$M)
ABL Facility (12/31/19)	\$130	\$640
Term Loan (12/31/19)	\$725	\$725
Senior Unsecured Notes 6.125% 2023	\$350	\$350
Senior Unsecured Notes 6.625% 2026	\$500	\$500
Total	\$1,705	\$2,215

New Capital Structure

	Outstanding (\$M)	Amount (\$M)
ABL Facility (12/31/19)	\$130	\$640
Term Loan (12/31/19)	\$725	\$725
Senior Secured Notes Variable Rate 2025 (1L)	\$190	\$190
Senior Secured Notes 15% 2025 (1L)	\$110	\$110
Senior Secured Notes 10% 2026 (2L)	\$100	\$100
Total	\$1,255	\$1,765

The company, with a new capital structure, will **recognize a ~\$450mln reduction in unsecured debt reducing yearly interest payments by ~\$10mln**.

Thesis:

Due to uncertainty in the global market from COVID-19, the high risk of bankruptcy in the retail sector, and the rapid disruption from e-commerce, investments in retail have largely been too risky for most investors.

- After the announcement last Friday, the **value of the PRTY 2023 notes went up more than 3x from .05 to .16 while the PRTY 2026 notes rose in price similarly from .04 to .15**.

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- The first lien Party City Exchange Notes due 2025 are **ranked Pari Passu with the senior credit facilities and have identical collateral to the senior credit facilities. An interest rate of LIBOR + 500 will be paid in cash semiannually.**
- The second lien Issuer Exchange Notes due 2026 will pay 10% per year, 5% in cash and 5% in kind or all in kind.
- The new money first lien issuer notes due 2025 will pay 15% interest per year, 10% in cash and 5% in kind.
- Retail as an industry has not been forgiving with many bankruptcies moving towards Chapter 7 liquidation and restructured entities not performing as expected
- In a recent presentation, the company indicated that they needed ~\$75-\$100M in additional liquidity (accomplished through the rights offering) for 2020. **\$40M of the rights offering has been purchase in a private placement by Barings and 52% of noteholders have agreed to the note exchange** signaling institutional support.

Scenario Analysis:

Bond & Equity Distribution

TSA Notes	Outstanding (\$M)	Price (\$)	Current Value (\$M)			
Senior Notes 6.125% 2023	350	0.17	58			
Senior Notes 6.625% 2026	500	0.16	79			
New Notes	Outstanding (\$M)	Price (\$)	Current Value (\$M)	2023 recovery	2026 recovery	
Senior Secured Notes Variable Rate 2025 (1L) ²	\$185	0.95	\$176	\$87.9	\$87.9	Pari Passu
Senior Secured Notes 10% 2026 (2L) ²	\$100	0.95	\$95	\$48	\$48	Pari Passu
Equity Portion of TSA	Shares Outstanding (M)	Float	% allocated (TSA)	Current Price	Price Dilution	Value
Equity	94.49	71.85	19.90%	\$1.47	\$1.18	\$22.14
Rights Offering						
Senior Secured Notes 15% 2025 (1L) ¹	\$100	1	\$100	\$25	\$35	Pro Rata ³

Return Profile	Sn. Uns. 2023	Sn. Uns. 2026
Initial Investment	\$58	\$79
Rights Offering Participation	\$25	\$35
Total Investment	\$82	\$114
Total Debt Return	\$135.4	\$135.4
Rights Offering Premium (Pro Rata) ⁴	\$2.5	\$3.5
Equity Recovery (Pari Passu)	\$11.1	\$11.1
Total Return	\$148.9	\$150.0

Return Analysis	Sn. Uns. 2023	Sn. Uns. 2026
ROI	158%	91%
ROI (Equity Value = 0)	139%	77%
MoM multiple	2.6x	1.9x
MoM multiple (Equity Value = 0)	2.4x	1.8x

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Through an analysis of the exchange, we arrive at a **ROI of 158% for the 2023 notes and a return of 91% for the 2026 notes**, if equity value remains at a diluted level. In the case of a bankruptcy and subsequent elimination of any equity value, returns would only decline slightly.

Discounted Cash Flow Analysis:

All figures in \$M	2017	2018	2019	2020F*	2021F*	2022F	2023F	2024F	Terminal Value	
Revenue	\$2,372	\$2,428	\$2,348	\$1,661	\$2,186	\$2,132	\$2,078	\$2,026	2024 EBITDA	\$249
Adjusted EBITDA	\$409	\$400	\$269	\$46	\$269	\$262	\$256	\$249	Terminal Multiple	4.0x
Less D&A	\$85	\$79	\$81	\$81	\$81	\$81	\$81	\$81	Terminal Value	\$997
Less Taxes	\$256	\$254	\$149	(\$27)	\$148	\$143	\$138	\$133		
Add D&A	\$341	\$333	\$230	\$54	\$229	\$224	\$219	\$214		
Capital Expenditures	(\$142)	(\$151)	\$164	\$172	\$180	\$189	\$199	\$209		
Change in NWC	\$30	\$154	(\$6)	\$59	\$59	\$59	\$59	\$59		
FCF	169	27	\$60	(\$59)	\$108	\$94	\$79	\$64		
Discounted FCF				(\$59)	\$99	\$79	\$61	\$45		

Enterprise Value	\$1,222
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Assumptions	
Revenue Growth Rate	-2.5%
EBITDA Growth Rate	-2.5%
Capex Growth Rate	5%
	Avg. '17-
Change in NWC	'19

Terminal Multiple	2024F EBITDA				
	150	200	250	300	350
2	300	400	500	600	700
3	450	600	750	900	1050
4	600	800	1000	1200	1400
5	750	1000	1250	1500	1750
6	900	1200	1500	1800	2100

Footnotes:
*Management provided revenue and EBITDA estimates

WACC	9.3%
Cost of Equity	
Rf	0.65%
Beta	2.66
Market Risk Premium	5.60%
Weight of Equity	0.47
Ke	15.55%
Cost of Debt	
Blended Interest Rate	4.56%
Tax Rate	21%
Weight of Debt	0.53
After tax cost of debt	4%

As Party City has no true comparable set of companies, a discounted cash flow with conservative assumptions had to be made to better visualize the company's performance as an operating entity. Sales have been declining YOY and have been reflected post 2021, assuming a recovery plan by management is formalized. Capex is still expected to increase to maintain stores although management has been open about closing any redundant locations. A terminal value of ~\$1.2bln can be determined which would allow salvageability for the equity value portion of the exchange while ensuring payout for the debt holders.

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Considerations:

1. **Timing:** As of the 8-K issued on 5/29/20, Party City expects to have definitive docs agreed upon by July 28 2020 and the exchange transaction as well as rights offering to have a settlement date of July 31 2020
2. **Bankruptcy Risk:** Retail has been in secular distress with recent bankruptcies including Neiman Marcus and JC Penny this month alone, which Party City is not immune to. This is further exacerbated by Covid-19 which has caused further financial concerns for the company.
3. **Liquidity/Availability of the bonds:** Due to the timing of this transaction, acquiring the 2023 or 2026 bonds might prove to be a challenge for non-institutional individuals. As of 5/29/20, **52% of all bond holders, have agreed to the exchange thereby limiting any sales**, which only leaves a maximum of \$408mln in available bonds for purchase.

Appendix I: Scenario Analysis Footnotes**Footnotes:**

¹Barings allocated \$40M for private placement as of 5/28

²5% discount in price assumed for issuance cost & other fees

³Senior Secured Notes due 2025 are confirmed Pro Rata

⁴ Aggregate premium of \$5M paid for private placement participation in rights offering

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Appendix II: Liquidation Analysis

Due to the high-risk nature of retail investments and specifically for Party City, a liquidation analysis has been done. Due to lack of subsidiary specific financials, I have assumed that the senior secured notes 15% due 2025 and the senior secured notes 10% due 2026 are subordinated to the ABL, Term Loan and the variable rate Senior Secured Notes due 2025. Actual recovery values might vary due to due to fees, discrepancies in recovery values and additional senior claims.

As of 12/31/19 (\$M)		Value (%)	Recovery Value (\$)
Cash	34.92	100%	\$34.92
A/R	149.11	85%	\$126.74
Inventory	658.42	50%	\$329.21
Net PPE	1050	50%	\$525.00
Net Intangibles	575.38	10%	\$57.54
Total			\$1,073
Claims Outsanding			\$1,255
Implied Recovery			86%

	Outstanding (\$M)	Recovery (\$M)	Recovery%
ABL Facility (12/31/19)	\$130	\$130	100%
Term Loan (12/31/19)	\$725	\$725	100%
Senior Secured Notes Variable Rate 2025 (1L)	\$190	\$190	100%
Senior Secured Notes 15% 2025 (1L)	\$110	\$28	25%
Senior Secured Notes 10% 2026 (2L)	\$100	\$0	0%
Total	\$1,255	\$1,073	

\$M	Sr. Uns 2023	Sr Uns. 2026
Initial Investment Value	\$82	\$114
Notional Debt and Equity Value (Post Exchange)	\$148.92	\$149.97
Net Investment Entry Value	0.55	0.76
Sale of Equity at diluted price	\$11.1	\$11.1
Liquidation Recovery (assume equal exchange and purchase across 3 notes)	\$109.00	\$109.00
Implied Recovery	132%	96%