

CREDIT MEMO

DISTRESSED CREDIT ANALYSIS & POST-MORTEMS
October 2023 | Sector: Specialty Retail | Party: Spirit/Hallmark | Author: Cathy Smith

RESTRUCTURING FAILURE

Party City: When Debt Reduction Can't Save a Dying Business

Post-mortem analysis of a failed bankruptcy restructuring. The specialty retailer eliminated nearly \$1 billion in debt, only to liquidate 14 months later—a case study in mistaking balance sheet repair for business model salvation.

Published October 2025

Party City's October 2023 bankruptcy emergence lasted just 14 months—a case study in mistaking balance sheet repair for business model salvation. The specialty retailer eliminated nearly \$1 billion in debt, closed 70 underperforming stores, and raised \$75 million in

fresh equity, only to file for liquidation bankruptcy in December 2024.

By February 2025, all 700+ stores were closed and 12,000 employees terminated. This post-mortem examines why the restructuring failed, identifies early warning signs visible in real-time, and extracts lessons for credit investors evaluating distressed situations.

KEY TAKEAWAYS

- October 12, 2023: Emerged from Chapter 11 bankruptcy
- Debt reduced from \$1.1B to \$230M in Second Lien Notes
- December 21, 2024: Filed for liquidation (14 months later)
- February 2025: All 700+ stores closed, 12,000 jobs eliminated

Executive Summary

Party City Holdings Inc. emerged from Chapter 11 bankruptcy on October 12, 2023, after reducing total debt from approximately \$1.5 billion to \$232 million in Second Lien PIK Tangle Notes.

Operational Deterioration Accelerated Post-Emergence

Comparable store sales declined 11.4% in 9M 2023 (pre-emergence), then 5.7% in 2024 (post-emergence). The consumer products division sales plummeted 24.8% year-over-year. The company closed an additional 27 stores in 2024 despite the "optimized footprint" from the first bankruptcy.

Capital Structure Proved Unsustainable Despite Deleveraging

The \$232 million Second Lien Notes at 12% interest created approximately \$28 million in annual cash burden. ABL facility liquidity evaporated as inventory values declined with sales. JPMorgan, as ABL agent, imposed a \$50 million discretionary reserve in December 2024 after a negative HICO inventory appraisal.

Liquidation Proceeds Minimal

ASSET	BUYER/RESULT	PROCEEDS
Store Leases (158)	Dollar Tree	\$14.5M
Store Leases (48)	Five Below	Included above
Intellectual Property	Ad Populum	\$20M
Inventory	Liquidation	30-40% of book
Total Recovery Pool		\$100-120M

ESTIMATED RECOVERIES

- ABL Facility: 30-40 cents on the dollar
- Second Lien Note holders (12% PIK tangle): 0-10 cents
- Equity holders: Zero

Debt reduction alone cannot salvage a business facing secular decline, intensifying competition, and no sustainable competitive advantages.

Party City's bankruptcy addressed a symptom (overleveraged balance sheet) but not the disease (broken business model). Credit investors who purchased the exit Second Lien Notes—

and establishing a new \$562 million asset-based lending (ABL) facility. Despite this dramatic deleveraging, the company filed for liquidation just 14 months later on December 21, 2024.

Two workforce reductions affected 680 corporate employees. CEO turnover occurred in August 2024, just 10 months post-emergence—a clear signal that the board recognized the post-emergence plan was failing.

September 2024 capital raise attempt failed—no lenders were willing to provide additional financing. On December 10, 2024, liquidity fell below ABL covenant minimums, triggering default and forcing immediate liquidation.

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Investment Thesis & Positioning

The Opportunity as Presented (October 2023)

At emergence, Party City's Second Lien Notes appeared attractive on paper. The security features included \$232 million principal amount, 12% PIK tangle interest (cash or paid-in-kind at company's option), and a second lien on substantially all assets. The maturity date of January 11, 2025 provided a 5+ year runway with a covenant-lite structure.

The restructuring accomplishments were impressive: elimination of \$1.3 billion in prepetition debt, closure of 70 underperforming stores (10% of footprint), renegotiated favorable lease terms on remaining locations, a \$75-million equity injection signaling management confidence, and a new \$562 million ABL facility providing a liquidity cushion.

THE BULL CASE REQUIRED BELIEVING

- Footprint rationalization would stabilize gross-EBITDA
- Footprint rationalization would improve unit economics
- E-commerce investments would narrow competitive gap to Amazon
- 12% PIK tangle yield provided for execution risk
- Second position provided downside protection
- Asset liquidation recovery would fill all losses

The Bear Case (That Proved Correct)

Secular Decline, Not Cyclical Weakness

Party City faced permanent shifts in consumer behavior and competitive dynamics. Amazon captured market share in party supplies through price and convenience advantages. Spirit Halloween's pop-up model dominated the Halloween season with lower fixed costs than year-round stores.

Dollar stores (Dollar Tree, Dollar General) offered acceptable party goods at 40-60% discounts. Post-COVID social gathering patterns reduced demand for large celebrations. The helium shortage—critical for balloon decorations—persisted structurally with no near-term resolution.

Deteriorating Competitive Position

Party City possessed no sustainable competitive advantages. The company had no pricing power, with Amazon and dollar stores consistently undercutting on price. Customer loyalty was transactional—consumers freely switched between retailers based on convenience and cost.

The company maintained no proprietary products or exclusive supplier relationships. It possessed no technology edge in e-commerce or in-store experience. Spirit Halloween proved more efficient with its seasonal pop-up model, eliminating the fixed-cost burden that crippled Party City.

ABL Structure Created Death Spiral

Asset-based lending facilities fed conservative but create pro-cyclical liquidity in declining businesses. As sales declined, they purchased at steep discounts, increased the borrowing base and triggered a liquidity crisis.

Party City's inventory optimization initiative paradoxically worsened the situation. When HICO renegotiated inventory in December 2024 at 40-60% discounts, the ABL facility eliminated remaining liquidity, forcing immediate liquidation filing.

No Path to Positive Free Cash Flow

METRIC	PRIOR (Q4 2023)	POST (Q4 TARGET)	ACTUAL (2024)
Revenue	\$1,200M	-\$1,200M	-\$1,200M (est)
Gross Margin	28.3%	32%	<28% (declining)
Operating CF	\$80M	Positive	\$(100M+)
Comp Sales	-11.4%	+2.5%	-12.5%

Even without debt service, the company burned ~\$100M+ annually in operating cash flow.

Why Sophisticated Investors Still Participated

Distressed Debt Fund Strategies

Some distressed debt funds operated on an "extend and pretend" strategy, expecting a second restructuring where they could recoup a loan-to-own strategy. The 12% yield appeared attractive in the 2023 rate environment for risk-tolerant capital.

Certain funds specialize in recovery plays rather than avoiding bankruptcies entirely. They viewed the Second Lien Notes as a free option on retail recovery without significant equity risk.

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Misreading of Distress Type

Many investors mistook this as **financial distress** (fixable with capital structure repair) rather than **business model failure** (terminal decline).

Financial Distress	Business Model Failure
Example: LBO with too much debt	Example: Party City
Business: Underlying business stable/growing	Business: Revenue declining structurally
Solution: Debt refinancing/asset problem	Solution: Late-to-market delays inevitable
Risk Profile: Credit investment + lending	Risk Profile: Credit investment + equity risk

Market Signaling Failure Risk

At emergence, implied enterprise valuation told a different story:

Exit Enterprise Value Calculation	
\$232M Second Lien Notes + \$75M Equity + \$6 ABL draw = -\$208M Enterprise Value	
October 2023 Revenue:	-\$1,700M
EV/Revenue Multiple:	0.11x

Comparable: Spirit Halloween Parent	
EV/Revenue Multiple:	0.5-1.0x
Party City Discount:	82%
Market pricing in failure	

When equity is nearly worthless and EV/Revenue is sub-0.2x, even "secured" debt is highly speculative.

Root Cause Analysis: Why the Restructuring Failed

1. Debt Reduction Alone Cannot Fix Business Model Failure

The Core Problem: Party City's bankruptcy addressed the symptom (unsustainable leverage) but not the disease (broken business model facing secular decline).

\$100M+ because revenue continued declining 10% annually, gross margins compressed, and fixed costs remained too high for the sales base.

Post-emergence debt service of approximately \$15M annually represented an EBITDA reduction from pre-bankruptcy levels of \$120M. Yet operating cash flow remained deeply negative at

through 1,500+ seasonal locations versus Party City's year-round stores, offered better outcome selection in competitive pricing, and carried no off-season losses.

Amazon Intensified Pressure: Supplier becomes increasingly commoditized. Amazon offered free 2-day shipping via Prime, lower prices (30-50% below Party City), customer reviews and recommendations, and algorithm-driven discovery features.

Dollar Stores Captured Low-End: Dollar Tree, Dollar General, and Five Below offered acceptable party goods—balloons, streamers, basic decorations—at 40-60% discounts, with convenient locations and no meaningful quality gap for commoditized products.

Spirit Halloween Continued Dominance: Halloween represents 30-40% of Party City's annual revenue. Spirit Halloween's pop-up model operated with lower fixed costs

Party City's inventory optimization initiative paradoxically worsened the situation. When HICO renegotiated inventory in December 2024 at 50-60% of book value, JPMorgan imposed a \$50 million reserve, eliminating remaining availability and forcing immediate liquidation.

3. ABL Facility Structure Created Death Spiral

How Asset-Based Lending Works: ABL facilities lend against collateral (inventory, receivables). As sales decline, inventory levels drop, which reduces the borrowing base.

At an enterprise value of approximately \$307 million on \$1,700 million in revenue, Party City ended at just 0.18x revenue—an 82% discount to specialty retail peers. The market was pricing in liquidation risk from day one.

DATE	INVENTORY	BORROWING BASE	ABL DRAWS	PAID (LITIGATION)
Oct 2023	\$60M	\$40M	\$10M	\$30M
Mar 2024	\$15M	\$40M	\$20M	\$20M
Sep 2024	\$45M	\$30M	\$20M	\$80M
Dec 2024	\$15M	\$20M	\$20M	\$0

As sales declined 35%, borrowing base declined 42%—faster than revenue.

4. No Equity Cushion to Absorb Losses

Post-emergence equity value of just \$75 million provided minimal cushion against the company's \$100 million annual cash burn. With such a thin equity buffer, the runway was only 9-12 months.

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5. Lack of Transparency Post-Defiling

Party City defiled from NASDAQ on October 13, 2023, eliminating quarterly earnings reports and SEC filings. This information asymmetry meant investors had limited visibility into the operational deterioration.

Without public disclosures, sophisticated monitoring required alternative data sources: location-based foot traffic data, employee review sentiment analysis, local news monitoring, and channel checks through store visits.

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Red Flag Timeline: Signals Visible in Real-Time

For investors monitoring Party City's Second Lien Notes in 2024, here's what was observable and when exit opportunities existed:

Q4 2023: Emergence Honeymoon

Public Information	Alternative Data Signals
Emergency announcement (Oct 12) Defiling from NASDAQ (Oct 13) Management optimistic messaging	Foot traffic down 15-20% vs 2022 Google search interest declining Bond pricing: 65-75 cents

Q2 2024: Warning Signs Intensify

- CRITICAL EVENTS**
- Corporate layoffs announced (~400 employees)
- Accelerated store closures reported in local media
- Trade publications noting vendor payment delays
- Gleanable reviews mentioning "cheap" and "no inventory"
- Bond pricing: 40-50 cents

Q3 2024: Red Lights Flashing

Exit Window Closing August 2024: September 2024: Bond Pricing: SELL SIGNAL: Second bankruptcy likely within 6 months	CEO Barry Livins departs Failed debt raise 20-30 cents
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Trading Implications

EXIT DATE	PRICE	RETURN FROM P&S	RETURN FROM 10c
Oct 2023 (Emergence)	70c	-36%	0%
Mar 2024	60c	-48%	-14%
Jun 2024	45c	-55%	-36%
Sep 2024	25c	-75%	-64%
Dec 2024	8c	-92%	-89%

Active monitoring and willingness to take losses in September 2024 could have avoided catastrophic losses. Distressed debt requires active trading, not buy-and-hold.

Recovery Analysis & Loss Quantification

Liquidation Asset Values

Store Lease Portfolio: Of 700+ leases, most were rejected with landlords receiving nothing. Dollar Tree acquired 150 leases and Five Below acquired 40, generating approximately \$14.5 million in total proceeds.

Inventory Liquidation: With book value of approximately \$350 million in filing, liquidation sales at 50-70% off retail generated estimated recovery of 30-40% of book value, or \$105-140 million.

Intellectual Property: The "Party City" brand name, trademarks, customer lists, and e-commerce domain sold to Ad Populum, a private equity firm, for approximately \$20 million.

Total Recovery Pool: \$145-185 million against more than \$400 million in claims.

Recovery Waterfall

Estimated Recoveries by Claim Type	100% recovery
Bankruptcy Admin Costs:	35-40 cents
ABL Facility (\$280M):	7-8 cents
Second Lien Notes (\$232M):	0 cents
General Unsecured:	0 cents
Equity:	0 cents

Even though Second Lien Notes were "secured," junior lien position meant subordination to the ABL facility. In retail liquidations, there's rarely enough value to pay even senior secured creditors in full.

Lien Attribution

For a Second Lien Note holder who purchased at emergence:

Purchase: \$100M notional at 78 cents = \$78M investment
Holding Period: Oct 2023 - Dec 2024 (14 months)
Recovery: 5 cents = \$5M
Loss: \$65M | Return: -82% | Annualized: -42%

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Lessons for Credit Investors

1. Operational Due Diligence Trumps Capital Structure Engineering

The Fundamental Question: "Would I invest equity in this business?" If the answer is no, don't buy the debt—regardless of seniority, covenants, or yield.

Party City's same-store sales declined 11.4% pre-bankruptcy and 9.5% post-bankruptcy. No amount of deleveraging fixes persistent negative revenue trends. Debt capacity is a function of cash flow, and when cash flow is deeply negative, debt becomes equity risk.

2. ABL Facilities Create Pro-Cyclical Liquidity

Asset-based lending facilities feed conservative but create death spirals in declining businesses. As sales decline, inventory drops, reducing the borrowing base and triggering liquidity crises.

When companies "optimize inventory," this often signals pro-conservation under distress. ABL covenant proration, or vendor payment delays, is distressed credit analysis, stress-test borrowing base under realistic downside scenarios, sales down 20-30%, inventory advance rates declining to 60-65%.

3. Post-Bankruptcy Equity Value Signals Debt Risk

- ESTIMATED RECOVERIES AS CREDIT QUALITY SIGNAL**
- >50% of EV: Investment-grade quality
- 30-50% of EV: Investment-grade/limited credit
- 10-30% of EV: Distressed credit
- <10% of EV: Terminal liquidation risk

Party City's equity was 24% of enterprise value at emergence—discounted from day one. When equity represents less than 30% of EV, you're buying equity-like risk, not debt.

4. Distressed Financial Distress From Business Model Failure

Financial Distress	Business Model Failure
Root Cause: Excessive leverage	Root Cause: Secular decline
Example: Retailer scaling or growing	Revenue Trend: Structurally declining
Risk Profile: Credit investment + lending	Risk Profile: Credit investment + equity risk
Example: Overleveraged LBO	Example: Party City

Party City faced Amazon eroding core sales, Spirit Halloween dominating the most profitable season, dollar stores capturing

price-sensitive customers, and post-COVID behavioral changes. No amount of debt reduction could reverse these secular forces.

5. Defiling Eliminates Transparency

When Party City defiled on October 13, 2023, it eliminated quarterly 10-Qs, annual 10-Ks, and management commentary. Without SEC filings, credit investors lacked visibility into quarterly results, cash flow, covenant compliance, and going concern warnings.

Alternative data became essential: location-based foot traffic, employee review sentiment, local news monitoring, channel checks, and credit card point data. When distressed companies defile, demand information rights in credit agreements and price in an "opacity premium" of 200-300 basis points.

6. Management Change Signal Exit Opportunities

CEO Barry Livins's departure in August 2024—just 10 months post-emergence—signaled that the board recognized the restructuring plan was failing. Historically, CEO departures at distressed companies within 12 months of restructuring signal renewed problems in 80% of cases.

The failed September 2024 capital raise attempt confirmed that sophisticated lenders reviewed financial statements and declined to provide capital. After these two events, Second Lien Notes traded at 20-30 cents—this was the exit window before December's liquidation filing.

7. "Secured" Debt ≠ Safe in Liquidations

SECTOR	SENIOR SECURED	JUNIOR SECURED	UNSECURED
Technology	60-80%	20-40%	10-20%
Manufacturing	50-70%	15-35%	5-15%
Retail	30-50%	0-15%	5%
Services	20-40%	0-10%	0%

Retail liquidations are particularly brutal. Inventory liquidates at 30-40% of book value, fixed assets have minimal secondary market value, and IP-based value is limited without an operating business.

8. Competitive Moat Analysis Is Essential

Party City possessed no sustainable competitive advantages: no network effects, no switching costs, no cost advantages from scale, no brand position commanding loyalty, and no regulatory barriers preventing competition.

Before investing in distressed credit, map the competitive landscape. Identify the company's moat, and assess whether competitive advantages are widening or eroding. If no moat exists and competition is intensifying, debt is speculative equity.

9. Debt Capacity Depends on Free Cash Flow

Despite \$100-120 million in EBITDA, Party City generated negative free cash flow due to working capital consumption and maintenance capex. Even with chronically reduced debt, the company couldn't service the \$28 million in annual Second Lien interest from operations.

When analyzing distressed credit, build cash flow models beyond EBITDA multiples. Subtract capex, working capital, and taxes to calculate free cash flow available for debt service. If FCF is less than interest expense, the debt structure is unsustainable.

10. Post-Bankruptcy Performance Requires Active Monitoring

Bankruptcy emergence is not a "reset button." Studies show 30-40% of companies that emerge from bankruptcy re-file within five years. Party City's timeline—from bankruptcy in January 2023, emergence in October 2023, second bankruptcy in December 2024—demonstrates this reality.

Post-bankruptcy credits require active management, not buy-and-hold strategies. Set alerts for management changes, monitor alternative data sources, and trade around events. The August CEO departure and September failed capital raise were public exit signals.

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Conclusion

Party City's journey from billion-dollar debt elimination to liquidation in just 14 months demonstrates that Chapter 11 emergence is not success—it merely resets the capital structure. When fundamental business problems persist, even dramatic debt reduction cannot prevent eventual failure.

The company eliminated \$1.3 billion in debt, closed 70 underperforming stores, renegotiated lease terms, and raised \$75 million in fresh equity. Yet revenue continued declining 9.5% annually, competitive position deteriorated as Amazon and Spirit Halloween gained share, gross margins compressed under cost pressures, and free cash flow remained deeply negative.

The Fundamental Lesson

Credit investors must distinguish between solvable financial distress and terminal business model failure. Financial distress involves too much debt on a viable business and is fixable through restructuring. Business model failure involves secular decline or obsolescence, and restructuring merely delays the inevitable.

Party City exemplified the latter. No amount of debt reduction could overcome the loss of Halloween dominance to Spirit Halloween's superior pop-up model, Amazon capturing share in holiday party supplies, dollar stores offering acceptable quality at steep discounts, post-COVID shifts in social gatherings, or the structural helium shortage impacting high-margin balloon sales.

The Five Critical Tests

When evaluating distressed situations, investors should ask:

DISTRESSED CREDIT EVALUATION FRAMEWORK

- 1. Financial distress or business model failure?** If the business can't generate positive FCF even with zero debt, it's terminal
- 2. Sustainable competitive advantages?** If competitors have no reason to stay loyal, liquidation is likely
- 3. What does equity valuation signal?** If equity is <30% of enterprise value, debt carries equity risk
- 4. Can I monitor this actively?** If delisted/private, alternative data sources and debt covenants are essential
- 5. What's the downside recovery in liquidation?** Model realistic asset liquidation values, not covenant protections

Party City failed all five tests.

The Ultimate Outcome

The Second Lien Notes—marketed as 12% secured debt with five-year maturity—returned 65 cents on the dollar. Investors who purchased at emergence (78 cents) suffered 82% losses. Those who held beyond the September 2024 exit window (CEO departure and failed capital raise) experienced near-total wipeout.

Debt reduction alone cannot salvage a business facing secular decline, intensifying competition, and no sustainable competitive advantages.

For Practitioners

This analysis prepares credit investors and restructuring advisors to answer critical questions: How do we differentiate between financial distress and business model failure? What early warning signs indicate liquidation risk? How do you assess competitive moats in distressed situations? When is "secured" debt actually unsecured?

Party City provides clear answers. The company's post-emergence deterioration was visible in real-time through alternative data, management actions, and market signals. Sophisticated investors who actively monitored these indicators could have exited at 20-30 cents in September 2024, avoiding the subsequent collapse to 5-8 cents.

Final Observations

The specialty retail sector faces ongoing challenges from e-commerce disruption, changing consumer behavior, and format competition. Party City's failure illustrates that brick-and-mortar retailers without differentiated offerings, pricing power, or operational efficiency cannot survive through financial engineering alone.