WINMARK CORP
Form 10-Q
July 27, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2012

or

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from to

Commission File Number: 000-22012

WINMARK CORPORATION

(Exact name of registrant as specified in its charter)

Minnesota	**41-1622691**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
605 Highway 169 North, Suite 400, Minneapolis, MN	**55441**
(Address of principal executive offices)	(Zip Code)

(763) 520-8500

(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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No x

Common stock, no par value, 5,026,698 shares outstanding as of July 20, 2012.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1: Financial Statements

WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED BALANCE SHEETS

(Unaudited)

		June 30, 2012		December 31, 2011
ASSETS				
Current Assets:				
Cash and cash equivalents	$	2,037,300	$	9,020,100
Marketable securities		116,600		1,043,800
Receivables, less allowance for doubtful accounts of $16,000 and $15,100		1,041,900		1,316,200
Net investment in leases - current		11,454,500		11,746,900
Income tax receivable		1,171,000		116,500
Inventories		84,600		68,500
Prepaid expenses		401,100		362,000
Total current assets		16,307,000		23,674,000
Net investment in leases - long-term		20,618,000		18,102,000
Long-term investments, less allowance for losses of $883,100 and $883,100		3,539,300		3,817,400
Property and equipment, net		1,323,500		1,474,800
Other assets		677,500		677,500
	$	42,465,300	$	47,745,700
LIABILITIES AND SHAREHOLDERS EQUITY				
Current Liabilities:				
Line of credit	$	12,800,000	$	
Accounts payable		1,252,300		1,460,300
Accrued liabilities		2,187,500		1,346,000
Discounted lease rentals		403,200		20,800
Rents received in advance		276,800		274,700
Deferred revenue		1,635,600		1,212,400
Deferred income taxes		3,487,900		3,464,800
Total current liabilities		22,043,300		7,779,000
Long-Term Liabilities:				
Discounted lease rentals		542,900		
Rents received in advance		152,200		269,400
Deferred revenue		882,800		844,300
Other liabilities		1,351,500		1,389,200
Deferred income taxes		2,607,100		2,355,100
Total long-term liabilities		5,536,500		4,858,000
Shareholders Equity:				
Common stock, no par, 10,000,000 shares authorized, 5,026,698 and 4,987,643 shares issued and outstanding				629,800
Accumulated other comprehensive income		2,200		17,000
Retained earnings		14,883,300		34,461,900
Total shareholders equity		14,885,500		35,108,700
	$	42,465,300	$	47,745,700

The accompanying notes are an integral part of these financial statements.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2012	**June 25, 2011**	**June 30, 2012**	**June 25, 2011**
REVENUE:				
Royalties	$ 7,693,900	$ 6,819,300	$ 15,982,400	$ 13,872,100
Leasing income	3,285,000	6,980,200	5,677,100	10,215,200
Merchandise sales	656,800	833,000	1,366,600	1,334,400
Franchise fees	270,000	245,000	555,000	320,000
Other	286,700	347,300	444,700	588,000
Total revenue	12,192,400	15,224,800	24,025,800	26,329,700
COST OF MERCHANDISE SOLD	633,500	794,200	1,297,800	1,277,100
LEASING EXPENSE	325,700	3,340,200	565,500	3,858,900
PROVISION FOR CREDIT LOSSES	(14,900)	(24,100)	(67,900)	21,300
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	5,221,600	5,030,400	10,357,700	9,876,300
Income from operations	6,026,500	6,084,100	11,872,700	11,296,100
LOSS FROM EQUITY INVESTMENTS	(240,700)	(142,900)	(278,100)	(219,900)
IMPAIRMENT OF INVESTMENT IN NOTES		(252,900)		(252,900)
INTEREST EXPENSE	(122,300)	(26,900)	(192,100)	(58,000)
INTEREST AND OTHER INCOME	(10,000)	13,900	36,300	31,100
Income before income taxes	5,653,500	5,675,300	11,438,800	10,796,400
PROVISION FOR INCOME TAXES	(2,249,100)	(2,275,100)	(4,518,400)	(4,369,900)
NET INCOME	$ 3,404,400	$ 3,400,200	$ 6,920,400	$ 6,426,500
EARNINGS PER SHARE BASIC	$ .67	$ .68	$ 1.37	$ 1.29
EARNINGS PER SHARE DILUTED	$ .65	$ .65	$ 1.31	$ 1.23
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	5,056,289	4,980,844	5,054,620	4,985,220
WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	5,268,245	5,239,443	5,274,223	5,227,468

The accompanying notes are an integral part of these financial statements.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30, 2012	**June 25, 2011**	**June 30, 2012**	**June 25, 2011**
NET INCOME	$ 3,404,400	$ 3,400,200	$ 6,920,400	$ 6,426,500
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX:				
Unrealized net gains (losses) on marketable securities:				
Unrealized holding net gains (losses) losses arising during period	3,600		3,600	(1,000)
Reclassification adjustment for net gains included in net income			(28,000)	
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX	3,600		(24,400)	(1,000)
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME:				
Unrealized net gains (losses) on marketable securities:				
Unrealized holding net gains (losses) losses arising during period	(1,400)		(1,400)	400
Reclassification adjustment for net gains included in net income			11,000	
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME	(1,400)		9,600	400
OTHER COMPREHENSIVE GAIN (LOSS), NET OF TAX	2,200		(14,800)	(600)
COMPREHENSIVE INCOME	$ 3,406,600	$ 3,400,200	$ 6,905,600	$ 6,425,900

The accompanying notes are an integral part of these financial statements.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Six Months Ended	
	June 30, 2012	**June 25, 2011**
OPERATING ACTIVITIES:		
Net income	$ 6,920,400	$ 6,426,500
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	219,400	242,700
Provision for credit losses	(67,900)	21,300
Compensation expense related to stock options	437,400	351,100
Deferred income taxes	275,100	
Loss (gain) on sale of marketable securities	(30,000)	600
Loss from equity investments	278,100	219,900
Impairment of investment in notes		252,900
Deferred initial direct costs	(414,200)	(179,600)
Amortization of deferred initial direct costs	273,100	335,800
Tax benefits on exercised stock options	(327,400)	(137,600)
Change in operating assets and liabilities:		
Receivables	274,300	197,600
Income tax receivable / payable	(717,500)	1,882,200
Inventories	(16,100)	35,600
Prepaid expenses	(39,100)	58,500
Accounts payable	(208,000)	765,100
Accrued and other liabilities	803,800	367,300
Rents received in advance and security deposits	167,500	19,300
Other assets		3,000
Deferred revenue	461,700	412,900
Net cash provided by operating activities	8,290,600	11,275,100
INVESTING ACTIVITIES:		
Purchase of long term investments		(1,000,000)
Proceeds from sale of marketable securities	1,313,500	160,400
Purchase of marketable securities	(380,700)	(8,400)
Purchase of property and equipment	(68,100)	(112,700)
Purchase of equipment for lease contracts	(10,913,900)	(10,947,800)
Principal collections on lease receivables	8,566,100	10,908,300
Net cash used for investing activities	(1,483,100)	(1,000,200)
FINANCING ACTIVITIES:		
Proceeds from borrowings on line of credit	17,600,000	1,500,000
Payments on line of credit	(4,800,000)	(10,300,000)
Repurchases of common stock	(2,574,700)	(3,313,500)
Proceeds from exercises of stock options	403,200	729,100
Dividends paid	(25,722,100)	(249,200)
Proceeds from discounted lease rentals	975,900	
Tax benefits on exercised stock options	327,400	137,600
Net cash used for financing activities	(13,790,300)	(11,496,000)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(6,982,800)	(1,221,100)
Cash and cash equivalents, beginning of period	9,020,100	2,257,100
Cash and cash equivalents, end of period	$ 2,037,300	$ 1,036,000
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest	$ 161,600	$ 130,900

Cash paid for income taxes	$ 5,024,300	$ 2,329,600

The accompanying notes are an integral part of these financial statements.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

1. Management s Interim Financial Statement Representation:

The accompanying consolidated condensed financial statements have been prepared by Winmark Corporation and subsidiaries (the Company), without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. The Company has a 52/53 week year which ends on the last Saturday in December. The information in the consolidated condensed financial statements includes normal recurring adjustments and reflects all adjustments which are, in the opinion of management, necessary for a fair presentation of such financial statements. The consolidated condensed financial statements and notes are presented in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions for Form 10-Q, and therefore do not contain certain information included in the Company s annual consolidated financial statements and notes. This report should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company s latest Annual Report on Form 10-K.

Revenues and operating results for the six months ended June 30, 2012 are not necessarily indicative of the results to be expected for the full year.

Reclassifications

Certain reclassifications of previously reported amounts have been made to conform to the current year presentation. Such reclassifications did not impact net income or shareholders equity as previously reported.

2. Organization and Business:

The Company offers licenses to operate franchises using the service marks Plato s Closet®, Play It Again Sports®, Once Upon A Child® and Music Go Round®. The Company also operates both middle market and small-ticket equipment leasing businesses under the Winmark Capital® and Wirth Business Credit® marks.

3. Fair Value Measurements:

The Company defines fair value as the price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Company uses three levels of inputs to measure fair value:

- Level 1 quoted prices in active markets for identical assets and liabilities.
- Level 2 observable inputs other than quoted prices in active markets for identical assets and liabilities.
- Level 3 unobservable inputs in which there is little or no market data available, which require the reporting entity to develop its own assumptions.

The Company s marketable securities were valued based on Level 1 inputs using quoted prices.

Due to their nature, the carrying value of cash equivalents, receivables, payables and debt obligations approximates fair value.

Table of Contents

4. Investments:

Marketable Securities

The following is a summary of marketable securities classified as available-for-sale securities:

	June 30, 2012		December 31, 2011	
	Cost	Fair Value	Cost	Fair Value
Equity securities	$ 113,000	$ 116,600	$ 1,015,800	$ 1,043,800

The Company s unrealized gains and losses for marketable securities classified as available-for-sale securities in accumulated other comprehensive income are as follows:

	June 30, 2012	December 31, 2011
Unrealized gains	$ 3,600	$ 32,900
Unrealized losses		(4,900)
Net unrealized gains	$ 3,600	$ 28,000

The Company s realized gains and losses recognized on sales of available-for-sale marketable securities are as follows:

	Three Months Ended		Six Months Ended	
	June 30, 2012	June 25, 2011	June 30, 2012	June 25, 2011
Realized gains	$	$	$ 42,300	$
Realized losses			(12,300)	(600)
Net realized gains/(losses)	$	$	$ 30,000	$ (600)

Amounts reclassified out of accumulated other comprehensive income into earnings is determined by using the average cost of the security when sold.

Long-Term Investments

The Company has an investment in Tomsten, Inc. (Tomsten), the parent company of Archiver s retail chain. The Company has invested a total of $8.5 million in the purchase of common stock of Tomsten. The Company s investment currently represents 22.0% of the outstanding common stock of Tomsten. As of June 30, 2012, $0.3 million of the Company s investment, with a current carrying value of $2.2 million, is attributable to goodwill. The amount of goodwill was determined by calculating the difference between the Company s net investment in Tomsten less its pro rata share of Tomsten s net worth.

The Company has a $2.0 million investment in senior subordinated promissory notes with warrants in BridgeFunds Limited (BridgeFunds). BridgeFunds advances funds to claimants involved in civil litigation to cover litigation expenses. Monthly prepayment of the principal of such notes in an amount equal to Available Cash Flow (as defined within the agreements governing the notes) is required. In July 2012, the Company entered into an amendment to the agreement governing the notes whereby the maturity date of all of the outstanding notes was changed to June 30, 2013. During the six months ended June 30, 2012, the Company did not receive any payments of principal or interest on the notes. The Company stopped accruing interest on this investment as of September 30, 2010. The Company has deemed this investment to be impaired, and in evaluating the investment for impairment has determined that its present value of expected future cash flows, discounted at the effective interest rate on the notes of 15%, is less than the recorded investment in the notes. In developing its estimate of expected future cash flows, the Company used certain information obtained from BridgeFunds concerning existing liabilities, claimant cases outstanding and historical default rates on claimant advances, and made certain

Table of Contents

assumptions regarding the timing of case settlements, the payment of future liabilities and future default rates. The Company recognized $883,100 in impairment charges during 2011 and established a corresponding valuation allowance accordingly. Based upon the Company s estimate of expected future cash flows as of June 30, 2012, there were no additional impairment charges during the six month period then ended. As of June 30, 2012, the $1.3 million net investment balance inclusive of $0.2 million of related interest receivable is classified as long-term based on expected payments from Available Cash Flow.

5. Investment in Leasing Operations:

Investment in leasing operations consists of the following:

	June 30, 2012	December 31, 2011
Direct financing and sales-type leases:		
Minimum lease payments receivable	$ 27,709,500	$ 27,413,300
Estimated residual value of equipment	2,904,200	2,764,400
Unearned lease income net of initial direct costs deferred	(4,575,700)	(4,217,000)
Security deposits	(2,731,300)	(2,448,800)
Equipment installed on leases not yet commenced	9,087,700	6,489,200
Total investment in direct financing and sales-type leases	32,394,400	30,001,100
Allowance for credit losses	(785,800)	(803,800)
Net investment in direct financing and sales-type leases	31,608,600	29,197,300
Operating leases:		
Operating lease assets	1,131,300	1,218,900
Less accumulated depreciation and amortization	(667,400)	(567,300)
Net investment in operating leases	463,900	651,600
Total net investment in leasing operations	$ 32,072,500	$ 29,848,900

As of June 30, 2012, the $32.1 million total net investment in leases consists of $11.5 million classified as current and $20.6 million classified as long-term. As of December 31, 2011, the $29.8 million total net investment in leases consists of $11.7 million classified as current and $18.1 million classified as long-term.

As of June 30, 2012, leased assets with one customer approximated 11% of the Company s total assets.

Future minimum lease payments receivable under lease contracts and the amortization of unearned lease income, net of initial direct costs deferred, is as follows for the remainder of fiscal 2012 and the full fiscal years thereafter as of June 30, 2012:

	Direct Financing and Sales-Type Leases		Operating Leases
	Minimum Lease Payments Receivable	Income Amortization	Minimum Lease Payments Receivable
2012	$ 7,940,500	$ 2,103,800	$ 653,400
2013	11,989,200	1,918,400	1,517,800
2014	5,765,400	466,700	132,400

2015	1,515,200	81,000
2016	499,200	5,800
Thereafter		