WINMARK CORP
Form 10-Q
April 25, 2012
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# UNITED STATES

# SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

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# 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 March 31, 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**

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# 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<br>(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, 5,075,954 shares outstanding as of April 18, 2012.

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**WINMARK CORPORATION AND SUBSIDIARIES**

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PART I. FINANCIAL INFORMATION

**ITEM 1: Financial Statements**

**WINMARK CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED CONDENSED BALANCE SHEETS**

(Unaudited)

| | | March 31, 2012 | | December 31, 2011 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Current Assets: | | | | |
| Cash and cash equivalents | $ | 2,093,400 | $ | 9,020,100 |
| Marketable securities | | | | 1,043,800 |
| Receivables, less allowance for doubtful accounts of $16,700 and $15,100 | | 1,282,400 | | 1,316,200 |
| Net investment in leases - current | | 11,465,300 | | 11,746,900 |
| Income tax receivable | | | | 116,500 |
| Inventories | | 69,100 | | 68,500 |
| Prepaid expenses | | 437,400 | | 362,000 |
| Total current assets | | 15,347,600 | | 23,674,000 |
| Net investment in leases - long-term | | 18,096,700 | | 18,102,000 |
| Long-term investments, less allowance for losses of $883,100 and $883,100 | | 3,780,000 | | 3,817,400 |
| Property and equipment, net | | 1,384,000 | | 1,474,800 |
| Other assets | | 677,500 | | 677,500 |
| | $ | 39,285,800 | $ | 47,745,700 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | | |
| Current Liabilities: | | | | |
| Line of credit | $ | 12,100,000 | $ | |
| Accounts payable | | 1,269,800 | | 1,460,300 |
| Income tax payable | | 58,200 | | |
| Accrued liabilities | | 1,709,900 | | 1,346,000 |
| Discounted lease rentals | | 13,900 | | 20,800 |
| Rents received in advance | | 282,000 | | 274,700 |
| Deferred revenue | | 1,376,800 | | 1,212,400 |
| Deferred income taxes | | 3,487,900 | | 3,464,800 |
| Total current liabilities | | 20,298,500 | | 7,779,000 |
| Long-Term Liabilities: | | | | |
| Rents received in advance | | 194,500 | | 269,400 |
| Deferred revenue | | 847,300 | | 844,300 |
| Other liabilities | | 1,314,200 | | 1,389,200 |
| Deferred income taxes | | 2,607,100 | | 2,355,100 |
| Total long-term liabilities | | 4,963,100 | | 4,858,000 |
| Shareholders Equity: | | | | |
| Common stock, no par, 10,000,000 shares authorized, 5,075,954 and 4,987,643 shares issued and outstanding | | 1,565,800 | | 629,800 |

| | | | | |
|---|---|---|---|---|
| Accumulated other comprehensive income | | | | 17,000 |
| Retained earnings | | 12,458,400 | | 34,461,900 |
| Total shareholders equity | | 14,024,200 | | 35,108,700 |
| | $ | 39,285,800 | $ | 47,745,700 |

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

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**WINMARK CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS**

(Unaudited)

| | Three Months Ended | |
|---|---|---|
| | **March 31, 2012** | **March 26, 2011** |
| REVENUE: | | |
| Royalties | $ 8,288,500 | $ 7,052,800 |
| Leasing income | 2,392,100 | 3,235,000 |
| Merchandise sales | 709,800 | 501,400 |
| Franchise fees | 285,000 | 75,000 |
| Other | 158,000 | 240,700 |
| Total revenue | 11,833,400 | 11,104,900 |
| COST OF MERCHANDISE SOLD | 664,300 | 482,900 |
| LEASING EXPENSE | 239,800 | 518,700 |
| PROVISION FOR CREDIT LOSSES | (53,000) | 45,400 |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 5,136,100 | 4,845,900 |
| Income from operations | 5,846,200 | 5,212,000 |
| LOSS FROM EQUITY INVESTMENTS | (37,400) | (77,000) |
| INTEREST EXPENSE | (69,800) | (31,100) |
| INTEREST AND OTHER INCOME | 46,300 | 17,200 |
| Income before income taxes | 5,785,300 | 5,121,100 |
| PROVISION FOR INCOME TAXES | (2,269,300) | (2,094,800) |
| NET INCOME | $ 3,516,000 | $ 3,026,300 |
| EARNINGS PER SHARE BASIC | $ .70 | $ .61 |
| EARNINGS PER SHARE DILUTED | $ .67 | $ .58 |
| WEIGHTED AVERAGE SHARES OUTSTANDING BASIC | 5,052,952 | 4,989,588 |
| WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED | 5,280,202 | 5,215,484 |

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

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**WINMARK CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME**

(Unaudited)

| | Three Months Ended March 31, 2012 | Three Months Ended March 26, 2011 |
|---|---|---|
| NET INCOME | $ 3,516,000 | $ 3,026,300 |
| OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX: | | |
| Unrealized net gains on marketable securities: | | |
| Reclassification adjustment for net gains included in net income | (28,000) | |
| OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX | (28,000) | |
| INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME: | | |
| Unrealized net gains on marketable securities: | | |
| Reclassification adjustment for net gains included in net income | 11,000 | |
| OTHER COMPREHENSIVE LOSS, NET OF TAX | (17,000) | |
| COMPREHENSIVE INCOME | $ 3,499,000 | $ 3,026,300 |

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

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**WINMARK CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**

(Unaudited)

| | Three Months Ended March 31, 2012 | Three Months Ended March 26, 2011 |
|---|---|---|
| OPERATING ACTIVITIES: | | |
| Net income | $ 3,516,000 | $ 3,026,300 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 114,500 | 120,500 |
| Provision for credit losses | (53,000) | 45,400 |
| Compensation expense related to stock options | 205,400 | 170,400 |
| Deferred income taxes | 275,100 | |
| Loss (gain) on sale of marketable securities | (30,000) | 600 |
| Loss from equity investments | 37,400 | 77,000 |
| Deferred initial direct costs | (152,000) | (52,100) |
| Amortization of deferred initial direct costs | 102,300 | 150,700 |
| Tax benefits on exercised stock options | (327,400) | (69,800) |
| Change in operating assets and liabilities: | | |
| Receivables | 33,800 | 492,300 |
| Income tax receivable / payable | 513,100 | 582,900 |
| Inventories | (600) | 38,100 |
| Prepaid expenses | (75,400) | (25,600) |
| Accounts payable | (190,500) | 1,161,700 |
| Accrued and other liabilities | 288,900 | 1,690,400 |
| Rents received in advance and security deposits | 107,600 | 76,200 |
| Other assets | | 3,000 |
| Deferred revenue | 167,400 | 216,800 |
| Net cash provided by operating activities | 4,532,600 | 7,704,800 |
| INVESTING ACTIVITIES: | | |
| Proceeds from sale of marketable securities | 1,311,600 | 160,400 |
| Purchase of marketable securities | (265,800) | |
| Purchase of property and equipment | (23,700) | (32,400) |
| Purchase of equipment for lease contracts | (4,338,000) | (4,720,000) |
| Principal collections on lease receivables | 4,545,500 | 4,405,700 |
| Net cash provided by (used for) investing activities | 1,229,600 | (186,300) |
| FINANCING ACTIVITIES: | | |
| Proceeds from borrowings on line of credit | 14,600,000 | |
| Payments on line of credit | (2,500,000) | (5,300,000) |
| Repurchases of common stock | | (2,499,300) |
| Proceeds from exercises of stock options | 403,200 | 421,300 |
| Dividends paid | (25,519,500) | (99,800) |
| Tax benefits on exercised stock options | 327,400 | 69,800 |
| Net cash used for financing activities | (12,688,900) | (7,408,000) |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (6,926,700) | 110,500 |
| Cash and cash equivalents, beginning of period | 9,020,100 | 2,257,100 |
| Cash and cash equivalents, end of period | $ 2,093,400 | $ 2,367,600 |
| SUPPLEMENTAL DISCLOSURES: | | |

| | | | | |
|---|---|---|---|---|
| Cash paid for interest | $ | 19,800 | $ | 90,200 |
| Cash paid for income taxes | $ | 1,481,100 | $ | 1,348,200 |

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

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**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 three months ended March 31, 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.

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**4. Investments:**

***Marketable Securities***

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

| | March 31, 2012 | | | | December 31, 2011 | | | |
|---|---|---|---|---|---|---|---|---|
| | Cost | | Fair Value | | Cost | | Fair Value | |
| Equity securities | $ | | $ | | $ | 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:

| | March 31, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| Unrealized gains | $ | | $ | 32,900 |
| Unrealized losses | | | | (4,900) |
| Net unrealized gains/(losses) | $ | | $ | 28,000 |

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

| | Three Months Ended | | | |
|---|---|---|---|---|
| | March 31, 2012 | | March 26, 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 March 31, 2012, $0.3 million of the Company s investment, with a current carrying value of $2.5 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, and the maturity date of the notes is June 30, 2012. During the three months ended March 31, 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 assumptions regarding the timing of case settlements, the payment of future liabilities and future default rates. The Company

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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 March 31, 2012, there were no additional impairment charges during the three month period then ended. As of March 31, 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:

| | | March 31, 2012 | | December 31, 2011 |
|---|---|---|---|---|
| Direct financing and sales-type leases: | | | | |
| Minimum lease payments receivable | $ | 27,040,200 | $ | 27,413,300 |
| Estimated residual value of equipment | | 2,992,700 | | 2,764,400 |
| Unearned lease income net of initial direct costs deferred | | (4,198,600) | | (4,217,000) |
| Security deposits | | (2,624,000) | | (2,448,800) |
| Equipment installed on leases not yet commenced | | 6,476,800 | | 6,489,200 |
| Total investment in direct financing and sales-type leases | | 29,687,100 | | 30,001,100 |
| Allowance for credit losses | | (759,200) | | (803,800) |
| Net investment in direct financing and sales-type leases | | 28,927,900 | | 29,197,300 |
| | | | | |
| Operating leases: | | | | |
| Operating lease assets | | 1,302,500 | | 1,218,900 |
| Less accumulated depreciation and amortization | | (668,400) | | (567,300) |
| Net investment in operating leases | | 634,100 | | 651,600 |
| | | | | |
| Total net investment in leasing operations | $ | 29,562,000 | $ | 29,848,900 |

As of March 31, 2012, the $29.6 million total net investment in leases consists of $11.5 million classified as current and $18.1 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 March 31, 2012, leased assets with one customer approximated 13% 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 March 31, 2012:

| | Direct Financing and Sales-Type Leases | | | | Operating Leases | |
|---|---|---|---|---|---|---|
| | | Minimum Lease Payments Receivable | | Income Amortization | | Minimum Lease Payments Receivable |
| 2012 | $ | 11,200,300 | $ | 2,343,800 | $ | 1,055,600 |
| 2013 | | 9,312,400 | | 1,402,400 | | 1,517,800 |

| | | | |
|---|---|---|---|
| 2014 | 4,776,900 | 366,900 | 132,400 |
| 2015 | 1,251,700 | 79,300 | |
| 2016 | 498,900 | 6,200 | |
| Thereafter | | | |
| | $ 27,040,200 | $ 4,198,600 | $ 2,705,800 |

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The activity in the allowance for credit losses for leasing operations during the first three months of 2012 and 2011, respectively, is as follows:

| | March 31, 2012 | March 26, 2011 |
|---|---|---|
| Balance at beginning of period | $ 803,800 | $ 907,800 |
| Provisions charged to expense | (53,000) | 45,400 |
| Recoveries | 34,100 | 25,100 |
| Deductions for amounts written-off | (25,700) | (117,800) |
| Balance at end of period | $ 759,200 | $ 860,500 |

The Company s investment in direct financing and sales-type leases ( Investment In Leases ) and allowance for credit losses by loss evaluation methodology are as follows:

| | March 31, 2012 | | December 31, 2011 | |
|---|---|---|---|---|
| | Investment In Leases | Allowance for Credit Losses | Investment In Leases | Allowance for Credit Losses |
| Collectively evaluated for loss potential | $ 29,687,100 | $ 759,200 | $ 30,001,100 | $ 803,800 |
| Individually evaluated for loss potential | | | | |
| Total | $ 29,687,100 | $ 759,200 | $ 30,001,100 | $ 803,800 |

The Company s key credit quality indicator for its investment in direct financing and sales-type leases is the status of the lease, defined as accruing or non-accruing. Leases that are accruing income are considered to have a lower risk of loss. Non-accrual leases are those that the Company believes have a higher risk of loss. The following table sets forth information regarding the Company s accruing and non-accrual leases. Delinquent balances are determined based on the contractual terms of the lease.

| | March 31, 2012 | | | | |
|---|---|---|---|---|---|
| | 0-60 Days Delinquent and Accruing | 61-90 Days Delinquent and Accruing | Over 90 Days Delinquent and Accruing | Non-Accrual | Total |
| Middle-Market | $ 26,835,700 | $ | $ | $ 94,300 | $ 26,930,000 |
| Small-Ticket | 2,757,100 | | | | 2,757,100 |
| Total Investment in Leases | $ 29,592,800 | $ | $ | $ 94,300 | $ 29,687,100 |

December 31, 2011