

WINMARK CORP
Form 10-Q
October 21, 2015
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 September 26, 2015

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

(State or other jurisdiction of incorporation or organization)

41-1622691

(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 No

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 No

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

Accelerated filer

Non-accelerated filer
(Do not check if a smaller reporting company)

Smaller reporting company

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

Common stock, no par value, 4,128,031 shares outstanding as of October 12, 2015.

Table of Contents

WINMARK CORPORATION AND SUBSIDIARIES

INDEX

	PAGE
<u>PART I.</u>	
<u>FINANCIAL INFORMATION</u>	
<u>Item 1.</u>	
<u>Financial Statements (Unaudited)</u>	
<u>CONSOLIDATED CONDENSED BALANCE SHEETS:</u> <u>September 26, 2015 and December 27, 2014</u>	3
<u>CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS:</u> <u>Three Months Ended September 26, 2015 and September 27, 2014</u> <u>Nine Months Ended September 26, 2015 and September 27, 2014</u>	4
<u>CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME:</u> <u>Three Months Ended September 26, 2015 and September 27, 2014</u> <u>Nine Months Ended September 26, 2015 and September 27, 2014</u>	5
<u>CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS:</u> <u>Nine Months Ended September 26, 2015 and September 27, 2014</u>	6
<u>NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS</u>	7 14
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	15 24
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	24
<u>Item 4.</u>	
<u>Controls and Procedures</u>	24
<u>PART II.</u>	
<u>OTHER INFORMATION</u>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	25
<u>Item 1A.</u>	
<u>Risk Factors</u>	25
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	26
<u>Item 3.</u>	
<u>Defaults Upon Senior Securities</u>	26
<u>Item 4.</u>	
<u>Mine Safety Disclosures</u>	26
<u>Item 5.</u>	
<u>Other Information</u>	26
<u>Item 6.</u>	
<u>Exhibits</u>	27
<u>SIGNATURES</u>	28

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1: Financial Statements

WINMARK CORPORATION AND SUBSIDIARIES
CONSOLIDATED CONDENSED BALANCE SHEETS

(Unaudited)

	September 26, 2015	December 27, 2014
ASSETS		
Current Assets:		
Cash and cash equivalents	\$ 1,060,700	\$ 2,089,700
Marketable securities	226,500	466,800
Receivables, less allowance for doubtful accounts of \$600 and \$1,600	1,314,200	1,328,200
Net investment in leases - current	18,260,700	19,831,600
Income tax receivable	855,000	4,163,900
Inventories	59,600	93,500
Prepaid expenses	757,500	467,400
Total current assets	22,534,200	28,441,100
Net investment in leases - long-term	21,994,700	24,188,900
Property and equipment, net	1,218,800	1,420,300
Other assets	607,500	677,500
Deferred income taxes	419,400	
	\$ 46,774,600	\$ 54,727,800
LIABILITIES AND SHAREHOLDERS EQUITY (DEFICIT)		
Current Liabilities:		
Line of credit	\$	\$ 18,500,000
Notes payable, net of unamortized debt issuance costs of \$11,300	1,988,700	
Accounts payable	1,208,400	1,955,500
Accrued liabilities	3,139,800	1,759,200
Discounted lease rentals	75,800	227,300
Deferred revenue	2,139,200	2,142,600
Deferred income taxes	2,846,400	4,412,600
Total current liabilities	11,398,300	28,997,200
Long-Term Liabilities:		
Line of credit	46,200,000	
Notes payable, net of unamortized debt issuance costs of \$96,800	22,403,200	
Discounted lease rentals		25,800
Deferred revenue	1,536,100	1,347,800
Other liabilities	1,248,800	1,403,200
Deferred income taxes		1,344,300
Total long-term liabilities	71,388,100	4,121,100
Shareholders Equity (Deficit):		
Common stock, no par value, 10,000,000 shares authorized, 4,128,031 and 4,998,512 shares issued and outstanding	434,700	422,400

Edgar Filing: WINMARK CORP - Form 10-Q

Accumulated other comprehensive loss	(33,700)	(37,100)
Retained earnings (accumulated deficit)	(36,412,800)	21,224,200
Total shareholders' equity (deficit)	(36,011,800)	21,609,500
	\$ 46,774,600	\$ 54,727,800

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		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
REVENUE:				
Royalties	\$ 11,286,100	\$ 10,725,000	\$ 31,226,700	\$ 28,735,800
Leasing income	3,247,000	4,121,800	16,919,900	11,655,000
Merchandise sales	762,300	786,100	2,182,300	2,259,900
Franchise fees	483,200	558,200	1,253,500	1,514,700
Other	220,900	213,300	917,900	830,500
Total revenue	15,999,500	16,404,400	52,500,300	44,995,900
COST OF MERCHANDISE SOLD	711,600	742,300	2,055,600	2,156,300
LEASING EXPENSE	173,400	808,500	4,941,300	1,234,200
PROVISION FOR CREDIT LOSSES	38,800	(1,700)	(123,400)	26,100
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	5,733,900	5,677,600	18,226,700	17,874,500
Income from operations	9,341,800	9,177,700	27,400,100	23,704,800
INTEREST EXPENSE	(687,700)	(150,500)	(1,142,900)	(356,700)
INTEREST AND OTHER INCOME (EXPENSE)	(12,400)	27,200	(61,800)	28,200
Income before income taxes	8,641,700	9,054,400	26,195,400	23,376,300
PROVISION FOR INCOME TAXES	(3,302,100)	(3,431,400)	(10,050,100)	(8,920,600)
NET INCOME	\$ 5,339,600	\$ 5,623,000	\$ 16,145,300	\$ 14,455,700
EARNINGS PER SHARE BASIC	\$ 1.29	\$ 1.12	\$ 3.53	\$ 2.84
EARNINGS PER SHARE DILUTED	\$ 1.23	\$ 1.09	\$ 3.39	\$ 2.76
WEIGHTED AVERAGE SHARES OUTSTANDING BASIC	4,128,031	5,022,166	4,568,813	5,093,243
WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED	4,338,230	5,156,785	4,758,158	5,235,949

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		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
NET INCOME	\$ 5,339,600	\$ 5,623,000	\$ 16,145,300	\$ 14,455,700
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX:				
Unrealized net gains (losses) on marketable securities:				
Unrealized holding net gains (losses) arising during period	(30,700)	(61,400)	8,000	(56,200)
Reclassification adjustment for net gains included in net income			(2,300)	(3,800)
OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX	(30,700)	(61,400)	5,700	(60,000)
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME:				
Unrealized net gains/losses on marketable securities:				
Unrealized holding net gains/losses arising during period	11,600	23,300	(3,200)	21,400
Reclassification adjustment for net gains included in net income			900	1,400
INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME	11,600	23,300	(2,300)	22,800
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	(19,100)	(38,100)	3,400	(37,200)
COMPREHENSIVE INCOME	\$ 5,320,500	\$ 5,584,900	\$ 16,148,700	\$ 14,418,500

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)

	Nine Months Ended	
	September 26, 2015	September 27, 2014
OPERATING ACTIVITIES:		
Net income	\$ 16,145,300	\$ 14,455,700
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	322,800	304,600
Provision for credit losses	(123,400)	26,100
Compensation expense related to stock options	1,255,100	1,037,200
Deferred income taxes	(3,329,900)	(2,858,000)
(Gain) loss on sale of marketable securities	22,800	(12,700)
Deferred initial direct costs	(332,900)	(757,100)
Amortization of deferred initial direct costs	491,700	576,000
Tax benefits on exercised stock options	(16,600)	(74,700)
Change in operating assets and liabilities:		
Receivables	14,000	98,900
Income tax receivable / payable	3,323,200	290,900
Inventories	33,900	500
Prepaid expenses	(290,100)	(66,900)
Other assets	70,000	
Accounts payable	(747,100)	668,000
Accrued and other liabilities	1,133,300	1,522,600
Rents received in advance and security deposits	6,600	114,200
Deferred revenue	184,900	100,400
Net cash provided by operating activities	18,163,600	15,425,700
INVESTING ACTIVITIES:		
Proceeds from sale of marketable securities	299,000	603,200
Purchase of marketable securities	(75,800)	(629,800)
Purchase of property and equipment	(121,300)	(423,700)
Purchase of equipment for lease contracts	(18,516,900)	(21,394,100)
Principal collections on lease receivables	22,047,500	15,519,800
Net cash provided by (used for) investing activities	3,632,500	(6,324,600)
FINANCING ACTIVITIES:		
Proceeds from borrowings on line of credit	56,500,000	28,400,000
Payments on line of credit	(28,800,000)	(8,400,000)
Proceeds from borrowings on notes payable	25,000,000	
Payments on notes payable	(500,000)	
Repurchases of common stock	(74,261,500)	(11,564,800)
Proceeds from exercises of stock options	159,000	392,000
Dividends paid	(939,200)	(26,630,400)
Tax benefits on exercised stock options	16,600	74,700
Net cash used for financing activities	(22,825,100)	(17,728,500)
NET DECREASE IN CASH AND CASH EQUIVALENTS		
	(1,029,000)	(8,627,400)
Cash and cash equivalents, beginning of period	2,089,700	10,642,600
Cash and cash equivalents, end of period	\$ 1,060,700	\$ 2,015,200
SUPPLEMENTAL DISCLOSURES:		
Cash paid for interest	\$ 830,400	\$ 301,000
Cash paid for income taxes	\$ 10,056,800	\$ 11,487,700

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 nine months ended September 26, 2015 are not necessarily indicative of the results to be expected for the full year.

2. Organization and Business:

The Company offers licenses to operate franchises using the service marks Plato's Closet®, Once Upon A Child®, Play It Again Sports®, Music Go Round® and Style Encore®. 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.

Edgar Filing: WINMARK CORP - Form 10-Q

- 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:

	September 26, 2015		December 27, 2014	
	Cost	Fair Value	Cost	Fair Value
Equity securities	\$ 280,600	\$ 226,500	\$ 526,600	\$ 466,800

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

	September 26, 2015	December 27, 2014
Unrealized gains	\$ 3,300	\$ 3,300
Unrealized losses	(54,100)	(63,100)
Net unrealized losses	\$ (54,100)	\$ (59,800)

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

	Three Months Ended		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Realized gains	\$ 12,200	\$ 12,200	\$ 13,400	\$ 39,000
Realized losses			(36,200)	(26,300)
Net realized gains/(losses)	\$ 12,200	\$ 12,200	\$ (22,800)	\$ 12,700

Amounts reclassified out of accumulated other comprehensive loss into earnings is determined by using the average cost of the security when sold. Gross realized gains (losses) reclassified out of accumulated other comprehensive loss into earnings are included in Interest and Other Income (Expense) and the related tax benefits (expenses) are included in the Provision for Income Taxes lines of the Consolidated Condensed Statements of Operations.

5. Investment in Leasing Operations:

Investment in leasing operations consists of the following:

Edgar Filing: WINMARK CORP - Form 10-Q

	September 26, 2015	December 27, 2014
Direct financing and sales-type leases:		
Minimum lease payments receivable	\$ 36,246,600	\$ 40,739,900
Estimated residual value of equipment	4,811,200	4,347,100
Unearned lease income net of initial direct costs deferred	(4,983,200)	(6,061,100)
Security deposits	(3,274,900)	(3,253,200)
Equipment installed on leases not yet commenced	8,326,000	8,364,100
Total investment in direct financing and sales-type leases	41,125,700	44,136,800
Allowance for credit losses	(882,000)	(386,000)
Net investment in direct financing and sales-type leases	40,243,700	43,750,800
Operating leases:		
Operating lease assets	1,362,100	806,100
Less accumulated depreciation and amortization	(1,350,400)	(536,400)
Net investment in operating leases	11,700	269,700
Total net investment in leasing operations	\$ 40,255,400	\$ 44,020,500

Edgar Filing: WINMARK CORP - Form 10-Q

Table of Contents

As of September 26, 2015, the \$40.3 million total net investment in leases consists of \$18.3 million classified as current and \$22.0 million classified as long-term. As of December 27, 2014, the \$44.0 million total net investment in leases consists of \$19.8 million classified as current and \$24.2 million classified as long-term.

As of September 26, 2015, leased assets with three customers approximated 18%, 13% and 12%, respectively, 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 2015 and the full fiscal years thereafter as of September 26, 2015:

	Direct Financing and Sales-Type Leases		Operating Leases	
	Minimum Lease	Income	Minimum Lease	
	Payments Receivable	Amortization	Payments Receivable	
2015	\$ 6,320,200	\$ 1,228,500	\$ 7,600	
2016	18,984,100	2,939,300		
2017	9,748,000	789,800		
2018	1,192,300	25,600		
2019	2,000			
Thereafter	\$ 36,246,600	\$ 4,983,200	\$ 7,600	

The activity in the allowance for credit losses for leasing operations during the first nine months of 2015 and 2014, respectively, is as follows:

	September 26, 2015		September 27, 2014	
Balance at beginning of period	\$	386,000	\$	822,700
Provisions charged to expense		(123,400)		26,100
Recoveries		628,700		98,500
Deductions for amounts written-off		(9,300)		(20,100)
Balance at end of period	\$	882,000	\$	927,200

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:

	September 26, 2015		December 27, 2014	
	Investment	Allowance for	Investment	Allowance for
	In Leases	Credit Losses	In Leases	Credit Losses
Collectively evaluated for loss potential	\$ 41,125,700	\$ 882,000	\$ 44,136,800	\$ 386,000
Individually evaluated for loss potential				
Total	\$ 41,125,700	\$ 882,000	\$ 44,136,800	\$ 386,000

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-accrual. Leases that are accruing income are considered to have a lower risk of loss. Non-accrual leases are those that the

Edgar Filing: WINMARK CORP - Form 10-Q

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.

Table of Contents

	0-60 Days Delinquent and Accruing	61-90 Days Delinquent and Accruing	September 26, 2015 Over 90 Days Delinquent and Accruing	Non-Accrual	Total
Middle-Market	\$ 39,972,700	\$	\$	\$	\$ 39,972,700
Small-Ticket	1,153,000				1,153,000
Total Investment in Leases	\$ 41,125,700	\$	\$	\$	\$ 41,125,700

	0-60 Days Delinquent and Accruing	61-90 Days Delinquent and Accruing	December 27, 2014 Over 90 Days Delinquent and Accruing	Non-Accrual	Total
Middle-Market	\$ 42,948,000	\$	\$	\$	\$ 42,948,000
Small-Ticket	1,188,800				1,188,800
Total Investment in Leases	\$ 44,136,800	\$	\$	\$	\$ 44,136,800

6. Recent Accounting Pronouncements:

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2014-09, *Revenue from Contracts with Customers*, which provides guidance for revenue recognition that supersedes existing revenue recognition guidance (but does not apply to nor supersede accounting guidance for lease contracts). The ASU's core principle is that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU also requires more detailed disclosures to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. As a result of the FASB's issuance of ASU 2015-14, *Revenue from Contracts with Customers: Deferral of the Effective Date*, which deferred the effective date of ASU 2014-09 for all entities by one year, such ASU is effective for reporting periods beginning after December 15, 2017, and should be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying the ASU recognized at the date of initial application. The new standard will become effective for the Company beginning with the first quarter of fiscal 2018. The Company is currently in the process of evaluating the impact of the adoption of this ASU on the Company's consolidated results.

In April 2015, the FASB issued ASU 2015-03, *Simplifying the Presentation of Debt Issuance Costs*, which amends existing guidance to require the presentation of debt issuance costs in the balance sheet as a deduction from the carrying amount of the related debt liability instead of a deferred charge (as an asset). The ASU is effective for reporting periods beginning after December 15, 2015, but early adoption is permitted. The Company early adopted the ASU for the fiscal year ending December 26, 2015, and applied its provision retrospectively. The adoption of this ASU resulted in the classification of \$108,100 of unamortized debt issuance costs related to Notes Payable as long-term debt within the Company's Consolidated Condensed Balance Sheet as of September 26, 2015. As the ASU is only applicable to debt issuance costs incurred by the Company for its Note Payable in fiscal 2015, no prior period information has been retrospectively adjusted. Other than this classification, the adoption of this ASU did not have an impact on the Company's consolidated condensed financial statements.

Table of Contents**7. Earnings Per Share:**

The following table sets forth the presentation of shares outstanding used in the calculation of basic and diluted earnings per share (EPS):

	Three Months Ended		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Denominator for basic EPS weighted average common shares	4,128,031	5,022,166	4,568,813	5,093,243
Dilutive shares associated with option plans	210,199	134,619	189,345	142,706
Denominator for diluted EPS weighted average common shares and dilutive potential common shares	4,338,230	5,156,785	4,758,158	5,235,949
Options excluded from EPS calculation anti-dilutive	5,309	32,169	16,961	25,676

8. Shareholders Equity (Deficit):*Dividends*

On January 28, 2015, the Company's Board of Directors approved the payment of a \$0.06 per share quarterly cash dividend to shareholders of record at the close of business on February 11, 2015, which was paid on March 2, 2015.

On April 29, 2015, the Company's Board of Directors approved the payment of a \$0.07 per share quarterly cash dividend to shareholders of record at the close of business on May 13, 2015, which was paid on June 1, 2015.

On July 29, 2015, the Company's Board of Directors approved the payment of a \$0.07 per share quarterly cash dividend to shareholders of record at the close of business on August 12, 2015, which was paid on September 1, 2015.

Repurchase of Common Stock

In April 2015, the Company's Board of Directors authorized the repurchase of up to 875,000 shares of our common stock for a price of \$84.72 per share through a tender offer (the Tender Offer). The Tender Offer began on the date of the announcement, April 15, 2015 and expired on May 13, 2015. Upon expiration, the Company accepted for payment 875,000 shares for a total purchase price of approximately \$74.3 million, including fees and expenses related to the Tender Offer.

Edgar Filing: WINMARK CORP - Form 10-Q

Under a previous Board of Directors authorization, as of September 26, 2015, the Company has the ability to repurchase an additional 166,700 shares of its common stock. Repurchases may be made from time to time at prevailing prices, subject to certain restrictions on volume, pricing and timing.

Stock Option Plans and Stock-Based Compensation

The Company had authorized up to 750,000 shares of common stock be reserved for granting either nonqualified or incentive stock options to officers and key employees under the Company's 2001 Stock Option Plan (the 2001 Plan). The 2001 Plan expired on February 20, 2011. The Company has authorized up to 500,000 shares of common stock to be reserved for granting either nonqualified or incentive stock options to officers and key employees under the Company's 2010 Stock Option Plan (the 2010 Plan).

Edgar Filing: WINMARK CORP - Form 10-Q

Table of Contents

The Company also sponsors a Stock Option Plan for Nonemployee Directors (the Nonemployee Directors Plan) and has reserved a total of 350,000 shares for issuance to directors of the Company who are not employees.

Stock option activity under the 2001 Plan, 2010 Plan and Nonemployee Directors Plan (collectively, the Option Plans) as of September 26, 2015 was as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (years)	Intrinsic Value
Outstanding at December 27, 2014	597,700	\$ 48.50	6.93	\$ 20,973,700
Granted	39,700	91.93		
Exercised	(5,106)	40.52		
Outstanding at September 26, 2015	632,294	\$ 51.29	6.41	\$ 30,798,700
Exercisable at September 26, 2015	397,392	\$ 38.58	5.28	\$ 24,405,900

The fair value of options granted under the Option Plans during the first nine months of 2015 and 2014 were estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions and results:

	Nine Months Ended	
	September 26, 2015	September 27, 2014
Risk free interest rate	1.68%	1.80%
Expected life (years)	6	6
Expected volatility	30.8%	34.1%
Dividend yield	1.34%	1.80%
Option fair value	\$ 25.48	\$ 19.23

During the nine months ended September 26, 2015, option holders surrendered 587 shares of previously owned common stock as payment for option shares exercised as provided for by the Option Plans. All unexercised options at September 26, 2015 have an exercise price equal to the fair market value on the date of the grant.

Compensation expense of \$1,255,100 and \$1,037,200 relating to the vested portion of the fair value of stock options granted was expensed to Selling, General and Administrative Expenses in the first nine months of 2015 and 2014, respectively. As of September 26, 2015, the Company had \$3.6 million of total unrecognized compensation expense related to stock options that is expected to be recognized over the remaining weighted average vesting period of approximately 2.3 years.

A reconciliation of common shares outstanding and total equity (deficit) from December 27, 2014 to September 26, 2015 is as follows:

Common Shares	Total Equity (Deficit)
--------------------------	-----------------------------------

Edgar Filing: WINMARK CORP - Form 10-Q

BALANCE, December 27, 2014	4,998,512	\$	21,609,500
Repurchase of common stock	(875,000)		(74,261,500)
Stock options exercised and related tax benefits	4,519		175,600
Compensation expense relating to stock options			1,255,100
Cash dividends			(939,200)
Comprehensive income			16,148,700
BALANCE, September 26, 2015	4,128,031	\$	(36,011,800)

Table of Contents

9. Debt:

Line of Credit

In April 2015, the Company's Line of Credit with the PrivateBank and Trust Company and BMO Harris Bank N.A. was amended to, among other things:

- Provide the consent of the lenders for the Tender Offer;
- Increase the aggregate commitments from \$35.0 million to \$60.0 million to partially fund the Tender Offer;
- Extend the termination date from February 28, 2018 to May 14, 2019;
- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer and amend the leverage ratio to allow for an increase in the maximum of such ratio for a period of approximately two years from the effective date of the amendment;
- Provide for a change in the applicable margin on the interest rate options based upon the leverage ratio;
- Provide for additional LIBOR interest periods of six months and twelve months and remove the fixed rate interest options; and
- Permit the Company to sell up to \$30 million in term notes to Prudential Investment Management, Inc., its affiliates and managed accounts (Prudential) to partially fund the Tender Offer.

During the first nine months of 2015, the Line of Credit was used to finance in part the Tender Offer and has been and will continue to be used for general corporate purposes. The Line of Credit is secured by a lien against substantially all of the Company's assets, contains customary financial conditions and covenants, and requires maintenance of minimum levels of debt service coverage and tangible net worth and maximum levels of leverage (all as defined within the Line of Credit). As of September 26, 2015, the Company was in compliance with all of its financial covenants. There were \$46.2 million in borrowings outstanding under the line of credit bearing interest ranging from 2.46% to 3.25%, leaving \$13.8 million available for additional borrowings.

Notes Payable

In May 2015, the Company entered into a \$25.0 million Note Agreement (the Note Agreement) with Prudential. Proceeds from the Note Agreement of \$25.0 million were used to fund in part the Tender Offer.

Edgar Filing: WINMARK CORP - Form 10-Q

The final maturity of the notes is 10 years. Interest at a rate of 5.50% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$500,000 quarterly for the first five years, and \$750,000 quarterly thereafter until the principal is paid in full. The notes may be prepaid, at the option of the Company, in whole or in part (in a minimum amount of \$1.0 million), but prepayments require payment of a Yield Maintenance Amount, as defined in the Note Agreement.

The Company's obligations under the Note Agreement are secured by a lien against substantially all of the Company's assets (as the notes rank *pari passu* with the Line of Credit), and the Note Agreement contains customary financial conditions and covenants, and requires maintenance of minimum levels of fixed charge coverage and tangible net worth and maximum levels of leverage (all as defined within the Note Agreement). As of September 26, 2015, the Company was in compliance with all of its financial covenants.

Table of Contents

In connection with the Note Agreement, the Company incurred \$112,800 in debt issuance costs, of which unamortized amounts are presented as a direct deduction from the carrying amount of the related liability.

10. Discounted Lease Rentals:

The Company utilized certain lease receivables and underlying equipment as collateral to borrow from financial institutions at a weighted average interest rate of 3.25% at September 26, 2015 on a non-recourse basis.

11. Segment Reporting:

The Company currently has two reportable business segments, franchising and leasing. The franchising segment franchises value-oriented retail store concepts that buy, sell, trade and consign merchandise. The leasing segment includes (i) Winmark Capital Corporation, a middle-market equipment leasing business and (ii) Wirth Business Credit, Inc., a small-ticket financing business. Segment reporting is intended to give financial statement users a better view of how the Company manages and evaluates its businesses. The Company's internal management reporting is the basis for the information disclosed for its business segments and includes allocation of shared-service costs. Segment assets are those that are directly used in or identified with segment operations, including cash, accounts receivable, prepaids, inventory, property and equipment and investment in leasing operations. Unallocated assets include corporate cash and cash equivalents, marketable securities, current and deferred tax amounts and other corporate assets. Inter-segment balances and transactions have been eliminated. The following tables summarize financial information by segment and provide a reconciliation of segment contribution to operating income:

	Three Months Ended		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Revenue:				
Franchising	\$ 12,752,500	\$ 12,282,600	\$ 35,580,400	\$ 33,340,900
Leasing	3,247,000	4,121,800	16,919,900	11,655,000
Total revenue	\$ 15,999,500	\$ 16,404,400	\$ 52,500,300	\$ 44,995,900
Reconciliation to operating income:				
Franchising segment contribution	\$ 7,827,500	\$ 7,132,700	\$ 19,679,000	\$ 17,145,100
Leasing segment contribution	1,514,300	2,045,000	7,721,100	6,559,700
Total operating income	\$ 9,341,800	\$ 9,177,700	\$ 27,400,100	\$ 23,704,800
Depreciation:				
Franchising	\$ 85,900	\$ 80,700	\$ 255,800	\$ 240,400
Leasing	22,700	21,500	67,000	64,200
Total depreciation	\$ 108,600	\$ 102,200	\$ 322,800	\$ 304,600

	As of	
	September 26, 2015	December 27, 2014
Identifiable assets:		
Franchising	\$ 3,336,100	\$ 3,258,300

Edgar Filing: WINMARK CORP - Form 10-Q

Leasing	40,739,800	44,870,800
Unallocated	2,698,700	6,598,700
Total	\$ 46,774,600	\$ 54,727,800

Table of Contents**ITEM 2: Management's Discussion and Analysis of Financial Condition and Results of Operations.***Overview*

As of September 26, 2015, we had 1,133 franchises operating under the Plato's Closet, Once Upon A Child, Play it Again Sports, Music Go Round and Style Encore brands and had a leasing portfolio of \$40.3 million. Management closely tracks the following financial criteria to evaluate current business operations and future prospects: royalties, leasing activity, and selling, general and administrative expenses.

Our most profitable source of franchising revenue is royalties received from our franchise partners. During the first nine months of 2015, our royalties increased \$2.5 million or 8.7% compared to the first nine months of 2014.

During the first nine months of 2015, we purchased \$18.5 million in equipment for lease customers compared to \$21.4 million in the first nine months of 2014. Overall, our leasing portfolio (net investment in leases – current and long-term) decreased to \$40.3 million at September 26, 2015 from \$44.0 million at December 27, 2014. Leasing income net of leasing expense during the first nine months of 2015 was \$12.0 million compared to \$10.4 million in the same period last year. Fluctuations in period-to-period leasing income and leasing expense result primarily from the manner and timing in which leasing income and leasing expense is recognized over the term of each particular lease in accordance with accounting guidance applicable to leasing. For this reason, we believe that more meaningful levels of leasing activity are the purchases of equipment for lease customers and the medium- to long-term trend in the size of the leasing portfolio.

Management continually monitors the level and timing of selling, general and administrative expenses. The major components of selling, general and administrative expenses include salaries, wages and benefits, advertising, travel, occupancy, legal and professional fees. During the first nine months of 2015, selling, general and administrative expense increased \$0.4 million, or 2.0%, compared to the first nine months of 2014.

Management also monitors several nonfinancial factors in evaluating the current business operations and future prospects including franchise openings and closings and franchise renewals. The following is a summary of our franchising activity for the first nine months ended September 26, 2015:

	TOTAL 12/27/14	OPENED	CLOSED	TOTAL 9/26/15	NINE MONTHS ENDED 9/26/15 AVAILABLE FOR RENEWAL	COMPLETED RENEWALS
<u>Plato's Closet</u>						
Franchises - US and Canada	426	24	0	450	18	18
<u>Once Upon A Child</u>						
Franchises - US and Canada	308	13	1	320	17	17
<u>Play It Again Sports</u>						
Franchises - US and Canada	301	4	10	295	20	20
<u>Music Go Round</u>						
Franchises - US	33	1	1	33	3	3

Edgar Filing: WINMARK CORP - Form 10-Q

Style Encore

Franchises - US	24	11	0	35	0	0
Total Franchised Stores	1,092	53	12	1,133	58	58

Table of Contents

Renewal activity is a key focus area for management. Our franchisees sign 10-year agreements with us. The renewal of existing franchise agreements as they approach their expiration is an indicator that management monitors to determine the health of our business and the preservation of future royalties. During the first nine months of 2015, we renewed 58 of the 58 franchise agreements available for renewal.

Our ability to grow our operating income is dependent on our ability to: (i) effectively support our franchise partners so that they produce higher revenues, (ii) open new franchises, (iii) increase lease originations and minimize write-offs in our leasing portfolio, and (iv) control our selling, general and administrative expenses.

Results of Operations

The following table sets forth selected information from our Consolidated Condensed Statements of Operations expressed as a percentage of total revenue:

	Three Months Ended		Nine Months Ended	
	September 26, 2015	September 27, 2014	September 26, 2015	September 27, 2014
Revenue:				
Royalties	70.5%	65.4%	59.5%	63.9%
Leasing income	20.3	25.1	32.2	25.9
Merchandise sales	4.8	4.8	4.2	5.0
Franchise fees	3.0	3.4	2.4	3.4
Other	1.4	1.3	1.7	1.8
Total revenue	100.0	100.0	100.0	100.0
Cost of merchandise sold				
Cost of merchandise sold	(4.5)	(4.5)	(3.9)	(4.8)
Leasing expense	(1.1)	(4.9)	(9.4)	(2.8)
Provision for credit losses	(0.2)		0.2	
Selling, general and administrative expenses	(35.8)	(34.6)	(34.7)	(39.7)
Income from operations	58.4	56.0	52.2	52.7
Interest expense	(4.3)	(0.9)	(2.2)	(0.8)
Interest and other income (expense)	(0.1)	0.1	(0.1)	
Income before income taxes	54.0	55.2	49.9	51.9
Provision for income taxes	(20.6)	(20.9)	(19.1)	(19.8)
Net income	33.4%	34.3%	30.8%	32.1%

Comparison of Three Months Ended September 26, 2015 to Three Months Ended September 27, 2014

Revenue

Revenues for the quarter ended September 26, 2015 totaled \$16.0 million compared to \$16.4 million for the comparable period in 2014.

Table of Contents

Royalties and Franchise Fees

Royalties increased to \$11.3 million for the third quarter of 2015 from \$10.7 million for the third quarter of 2014, a 5.2% increase. The increase was primarily due to higher Plato's Closet and Once Upon A Child royalties of \$0.2 million and \$0.2 million, respectively. The increase in royalties for these brands is primarily from having 31 additional Plato's Closet and 16 additional Once Upon A Child franchise stores in the third quarter of 2015 compared to the same period in 2014.

Franchise fees decreased to \$483,200 for the third quarter of 2015 compared to \$558,200 for the third quarter of 2014, primarily as a result of opening 5 fewer franchises in the 2015 period compared to the same period in 2014.

Leasing Income

Leasing income decreased to \$3.2 million for the third quarter of 2015 compared to \$4.1 million for the same period in 2014. The decrease is primarily due to the classification of certain leases in the 2014 period as sales-type leases in accordance with accounting guidance applicable to leases as well as a lower level of equipment sales to customers.

Merchandise Sales

Merchandise sales include the sale of product to franchisees either through our Computer Support Center or through the Play It Again Sports buying group (together, Direct Franchisee Sales). Direct Franchisee Sales decreased to \$762,300 for the third quarter of 2015 compared to \$786,100 in the same period of 2014.

Cost of Merchandise Sold

Cost of merchandise sold includes in-bound freight and the cost of merchandise associated with Direct Franchisee Sales. Cost of merchandise sold decreased to \$711,600 for the third quarter of 2015 compared to \$742,300 in the same period of 2014. Cost of merchandise sold as a percentage of Direct Franchisee Sales for the third quarter of 2015 and 2014 was 93.3% and 94.4%, respectively.

Leasing Expense

Leasing expense decreased to \$0.2 million for the third quarter of 2015 compared to \$0.8 million for the third quarter of 2014. The decrease is primarily due to a decrease in the associated cost of equipment sales to customers discussed above.

Provision for Credit Losses

Provision for credit losses was \$38,800 for the third quarter of 2015 compared to \$(1,700) for the third quarter of 2014.

Selling, General and Administrative

Selling, general and administrative expense of \$5.7 million for the third quarter of 2015 was comparable to the third quarter of 2014.

Table of Contents

Interest Expense

Interest expense increased to \$687,700 for the third quarter of 2015 compared to \$150,500 for the third quarter of 2014. The increase is primarily due to higher average corporate borrowings when compared to the same period last year.

Interest and Other Income

During the third quarter of 2015, we had interest and other income (expense) of \$(12,400) compared to \$27,200 of interest and other income in the third quarter of 2014. Interest and other income during the third quarter of 2014 included greater investment income from marketable securities than during the third quarter of 2015.

Income Taxes

The provision for income taxes was calculated at an effective rate of 38.2% and 37.9% for the third quarter of 2015 and 2014, respectively.

Comparison of Nine Months Ended September 26, 2015 to Nine Months Ended September 27, 2014

Revenue

Revenues for the first nine months of 2015 totaled \$52.5 million compared to \$45.0 million for the same period in 2014.

Royalties and Franchise Fees

Royalties increased to \$31.2 million for the first nine months of 2015 from \$28.7 million for the first nine months of 2014, an 8.7% increase. The increase was primarily due to higher Plato's Closet and Once Upon A Child royalties of \$1.1 million and \$0.8 million, respectively. The increase in royalties for these brands is due to having 31 additional Plato's Closet and 16 additional Once Upon A Child franchise stores in the first nine months of 2015 compared to the same period in 2014 as well as higher franchisee retail sales.

Edgar Filing: WINMARK CORP - Form 10-Q

Franchise fees decreased to \$1.3 million for the first nine months of 2015 compared to \$1.5 million for the first nine months of 2014, primarily as a result of opening 20 fewer franchises in the 2015 period compared to the same period in 2014.

Leasing Income

Leasing income increased to \$16.9 million for the first nine months of 2015 compared to \$11.7 million for the same period in 2014. The increase is primarily due to a higher level of equipment sales to customers.

Merchandise Sales

Merchandise sales include the sale of product to franchisees either through our Computer Support Center or through the Play It Again Sports buying group (together, Direct Franchisee Sales). Direct Franchisee Sales decreased to \$2.2 million for the first nine months of 2015 compared to \$2.3 million in the same period of 2014. The decrease is primarily due to a decrease in buying group purchases by our franchisees.

Table of Contents

Cost of Merchandise Sold

Cost of merchandise sold includes in-bound freight and the cost of merchandise associated with Direct Franchisee Sales. Cost of merchandise sold decreased to \$2.1 million for the first nine months of 2015 compared to \$2.2 million in the same period of 2014. The decrease was due to a decrease in Direct Franchisee Sales discussed above. Cost of merchandise sold as a percentage of Direct Franchisee Sales for the first nine months of 2015 and 2014 was 94.2% and 95.4%, respectively.

Leasing Expense

Leasing expense increased to \$4.9 million for the first nine months of 2015 compared to \$1.2 million for the first nine months of 2014. The increase is primarily due to an increase in the associated cost of equipment sales to customers discussed above.

Provision for Credit Losses

Provision for credit losses was \$(123,400) for the first nine months of 2015 compared to \$26,100 for the first nine months of 2014. The provision level for the first nine months of 2015 was impacted by net recoveries in the leasing portfolio. During the first nine months of 2015, we had total net recoveries of \$619,400 compared to \$78,400 for the first nine months of 2014.

Selling, General and Administrative

Selling, general and administrative expenses increased 2.0% to \$18.2 million in the first nine months of 2015 from \$17.9 million in the same period of 2014. The increase was primarily due to an increase in compensation expenses.

Interest Expense

Interest expense increased to \$1.1 million for the first nine months of 2015 compared to \$0.4 million for the first nine months of 2014. The increase is primarily due to higher average corporate borrowings when compared to the same period last year.

Interest and Other Income (Expense)

Edgar Filing: WINMARK CORP - Form 10-Q

During the first nine months of 2015, we had interest and other income (expense) of \$(61,800) compared to \$28,200 of interest and other income in the first nine months of 2014. Interest and other income (expense) during the first nine months of 2015 included losses on sales of marketable securities while interest and other income during the first nine months of 2014 included higher investment income and gains on sales of marketable securities. (See Note 4 Investments).

Income Taxes

The provision for income taxes was calculated at an effective rate of 38.4% and 38.2% for the first nine months of 2015 and 2014, respectively.

Segment Comparison of Three Months Ended

September 26, 2015 to Three Months Ended September 27, 2014

Franchising Segment Operating Income

The franchising segment's operating income for the third quarter of 2015 increased by \$0.7 million to \$7.8 million from \$7.1 million for the third quarter of 2014. The increase in segment contribution was primarily due to increased royalty revenue.

Table of Contents

Leasing Segment Operating Income

The leasing segment's operating income for the third quarter of 2015 decreased by \$0.5 million to \$1.5 million from \$2.0 million for the third quarter of 2014. The decrease in segment contribution was primarily due to a decrease in leasing income net of leasing expense.

Segment Comparison of Nine Months Ended

September 26, 2015 to Nine Months Ended September 27, 2014

Franchising Segment Operating Income

The franchising segment's operating income for the first nine months of 2015 increased by \$2.6 million to \$19.7 million from \$17.1 million for the first nine months of 2014. The increase in segment contribution was primarily due to increased royalty revenue.

Leasing Segment Operating Income

The leasing segment's operating income for the first nine months of 2015 increased by \$1.1 million to \$7.7 million from \$6.6 million for the first nine months of 2014. The increase in segment contribution was primarily due to an increase in leasing income net of leasing expense.

Liquidity and Capital Resources

Our primary sources of liquidity have historically been cash flow from operations and borrowings. The components of the consolidated condensed statements of operations that reduce our net income but do not affect our liquidity include non-cash items for depreciation and compensation expense related to stock options.

We ended the third quarter of 2015 with \$1.1 million in cash and cash equivalents compared to \$2.0 million in cash and cash equivalents at the end of the third quarter of 2014.

Operating activities provided \$18.2 million of cash during the first nine months of 2015 compared to \$15.4 million provided during the same period last year. The increase in cash provided by operating activities in the first nine months of 2015 compared to 2014 was primarily due to the increase in net income and a decrease in cash paid for income taxes.

Edgar Filing: WINMARK CORP - Form 10-Q

Investing activities provided \$3.6 million of cash during the first nine months of 2015. The 2015 activities consisted primarily of the purchase of equipment for lease customers of \$18.5 million and principal collections on lease receivables of \$22.0 million.

Financing activities used \$22.8 million of cash during the first nine months of 2015. Our most significant financing activities during the first nine months of 2015 consisted of \$74.3 million to repurchase 875,000 shares of our common stock in the Tender Offer (including fees and expenses), \$0.9 million for the payment of dividends and net borrowings on our line of credit and notes payable of \$52.2 million with such borrowings incurred primarily to fund in part the Tender Offer. (See Note 8 Shareholders Equity (Deficit) and Note 9 Debt).

As of September 26, 2015, we had no off balance sheet arrangements.

In April 2015, our Line of Credit with the PrivateBank and Trust Company and BMO Harris Bank N.A. was amended to, among other things:

- Provide the consent of the lenders for the Tender Offer;

Table of Contents

- Increase the aggregate commitments from \$35.0 million to \$60.0 million to partially fund the Tender Offer;
- Extend the termination date from February 28, 2018 to May 14, 2019;
- Amend the tangible net worth covenant calculation to remove the effect of the Tender Offer and amend the leverage ratio to allow for an increase in the maximum of such ratio for a period of approximately two years from the effective date of the amendment;
- Provide for a change in the applicable margin on the interest rate options based upon the leverage ratio;
- Provide for additional LIBOR interest periods of six months and twelve months and remove the fixed rate interest options; and
- Permit us to sell up to \$30 million in term notes to Prudential Investment Management, Inc., its affiliates and managed accounts (Prudential) to partially fund the Tender Offer.

During the first nine months of 2015, the Line of Credit was used to finance in part the Tender Offer and has been and will continue to be used for general corporate purposes. The Line of Credit is secured by a lien against substantially all of our assets, contains customary financial conditions and covenants, and requires maintenance of minimum levels of debt service coverage and tangible net worth and maximum levels of leverage (all as defined within the Line of Credit). There were \$46.2 million in borrowings outstanding under the line of credit bearing interest ranging from 2.46% to 3.25%, leaving \$13.8 million available for additional borrowings.

In May 2015, we entered into a \$25.0 million Note Agreement (the Note Agreement) with Prudential. Proceeds from the Note Agreement of \$25.0 million were used to fund in part the Tender Offer.

The final maturity of the notes is 10 years. Interest at a rate of 5.50% per annum on the outstanding principal balance is payable quarterly, along with required prepayments of the principal of \$500,000 quarterly for the first five years, and \$750,000 quarterly thereafter until the principal is paid in full. The notes may be prepaid, at our option, in whole or in part (in a minimum amount of \$1.0 million), but prepayments require payment of a Yield Maintenance Amount, as defined in the Note Agreement.

Our obligations under the Note Agreement are secured by a lien against substantially all of our assets, and the Note Agreement contains customary financial conditions and covenants, and requires maintenance of minimum levels of fixed charge coverage and tangible net worth and maximum levels of leverage (all as defined within the Note Agreement).

As of September 26, 2015, we were in compliance with all of the financial covenants under the Line of Credit and Note Agreement.

We incurred increased indebtedness in connection with the purchase of shares in the Tender Offer and, as a result, are more leveraged. We expect to generate the cash necessary to pay our expenses, finance our leasing business and to pay the principal and interest on all of our

Edgar Filing: WINMARK CORP - Form 10-Q

outstanding debt from cash flows provided by operating activities and by opportunistically using other means to repay or refinance our obligations as we determine appropriate. Our ability to pay our expenses, finance our leasing business and meet our debt service obligations depends on our future performance, which may be affected by financial, business, economic, and other factors including the risk factors described under Item 1A of our Form 10-K for the fiscal year ended December 27, 2014. If we do not have enough money to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell assets, borrow more money or raise equity. In such an event, we may not be able to refinance our debt, sell assets, borrow more money or raise equity on terms acceptable to us or at all. Also, our ability to carry out any of these activities on favorable terms, if at all, may be further impacted by any financial or credit crisis which may limit access to the credit markets and increase our cost of capital.

Table of Contents

We may utilize discounted lease financing to provide funds for a portion of our leasing activities. Rates for discounted lease financing reflect prevailing market interest rates and the credit standing of the lessees for which the payment stream of the leases are discounted. We believe that discounted lease financing will continue to be available to us at competitive rates of interest through the relationships we have established with financial institutions.

We believe that the combination of our cash on hand, the cash generated from our franchising business, cash generated from discounting sources and our Line of Credit will be adequate to fund our planned operations through 2016.

Critical Accounting Policies

The Company prepares the consolidated condensed financial statements of Winmark Corporation and Subsidiaries in conformity with accounting principles generally accepted in the United States of America. As such, the Company is required to make certain estimates, judgments and assumptions that it believes are reasonable based on information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the periods presented. There can be no assurance that actual results will not differ from these estimates. The critical accounting policies that the Company believes are most important to aid in fully understanding and evaluating the reported financial results include the following:

Revenue Recognition Royalty Revenue and Franchise Fees

The Company collects royalties from each retail franchise based on a percentage of retail store gross sales. The Company recognizes royalties as revenue when earned. At the end of each accounting period, estimates of royalty amounts due are made based on applying historical weekly sales information to the number of weeks of unreported franchisee sales. If there are significant changes in the actual performance of franchisees versus the Company's estimates, its royalty revenue would be impacted. During the first nine months of 2015, the Company collected \$12,100 more than it estimated at December 27, 2014. As of September 26, 2015, the Company's royalty receivable was \$1,189,900.

The Company collects initial franchise fees when franchise agreements are signed and recognizes the initial franchise fees as revenue when the franchise is opened, which is when the Company has performed substantially all initial services required by the franchise agreement. Franchise fees collected from franchisees but not yet recognized as income are recorded as deferred revenue in the liability section of the consolidated condensed balance sheet. As of September 26, 2015, deferred franchise fees were \$2,052,600.

Leasing Income Recognition

Leasing income for direct financing leases is recognized under the effective interest method. The effective interest method of income recognition applies a constant rate of interest equal to the internal rate of return on the lease. Generally, when a lease is more than 90 days delinquent (where more than three monthly payments are owed), the lease is classified as being on non-accrual and the Company stops recognizing leasing income on that date. Payments received on leases in non-accrual status generally reduce the lease

receivable. Leases on non-accrual status remain classified as such until there is sustained payment performance that, in the Company's judgment, would indicate that all contractual amounts will be collected in full.

Table of Contents

In certain circumstances, the Company may re-lease equipment in its existing portfolio. As this equipment may have a fair value greater than its carrying amount when re-leased, the Company may be required to account for the lease as a sales-type lease. At inception of a sales-type lease, revenue is recorded that consists of the present value of the future minimum lease payments discounted at the rate implicit in the lease. In subsequent periods, the recording of income is consistent with the accounting for a direct financing lease.

For leases that are accounted for as operating leases, income is recognized on a straight-line basis when payments under the lease contract are due.

Allowances for Credit Losses

The Company maintains an allowance for credit losses at an amount that it believes to be sufficient to absorb losses inherent in its existing lease portfolio as of the reporting dates. Leases are collectively evaluated for potential loss. The Company's methodology for determining the allowance for credit losses includes consideration of the level of delinquencies and non-accrual leases, historical net charge-off amounts and review of any significant concentrations.

A provision is charged against earnings to maintain the allowance for credit losses at the appropriate level. If the actual results are different from the Company's estimates, results could be different. The Company's policy is to charge-off against the allowance the estimated unrecoverable portion of accounts once they reach 121 days delinquent. (See Note 5 Investment in Leasing Operations).

Stock-Based Compensation

The Company currently uses the Black-Scholes option pricing model to determine the fair value of stock options. The determination of the fair value of the awards on the date of grant using an option-pricing model is affected by stock price as well as assumptions regarding a number of complex and subjective variables. These variables include implied volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

The Company evaluates the assumptions used to value awards on an annual basis. If factors change and the Company employs different assumptions for estimating stock-based compensation expense in future periods or if the Company decides to use a different valuation model, the future periods may differ significantly from what it has recorded in the current period and could materially affect operating income, net income and earnings per share.

Forward Looking Statements

Edgar Filing: WINMARK CORP - Form 10-Q

The statements contained in this Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations that are not strictly historical fact, including without limitation, the Company's belief that it will have adequate capital and reserves to meet its current and contingent obligations and operating needs, as well as its disclosures regarding market rate risk are forward looking statements made under the safe harbor provision of the Private Securities Litigation Reform Act. Such statements are based on management's current expectations as of the date of this Report, but involve risks, uncertainties and other factors that may cause actual results to differ materially from those contemplated by such forward looking statements. Investors are cautioned to consider these forward looking statements in light of important factors which may result in material variations between results contemplated by such forward looking statements and actual results and conditions. See the section appearing in our Annual Report on Form 10-K for the fiscal year ended December 27, 2014 entitled "Risk Factors" and Part II, Item 1A in this Report for a more complete discussion of certain factors that

Table of Contents

may cause the Company's actual results to differ from those in its forward looking statements. You should not place undue reliance on these forward-looking statements, which speak only as of the date they were made. The Company undertakes no obligation to revise or update publicly any forward-looking statements for any reason.

ITEM 3: Quantitative and Qualitative Disclosures About Market Risk

The Company incurs financial market risk in the form of interest rate risk. Risk can be quantified by measuring the financial impact of a near-term adverse increase in short-term interest rates. At September 26, 2015, the Company had available a \$60.0 million line of credit with The PrivateBank and Trust Company and BMO Harris Bank, N.A. The interest rates applicable to this agreement are based on either the bank's base rate or LIBOR for short-term borrowings (twelve months or less). The Company had \$46.2 million of debt outstanding at September 26, 2015 under this line of credit, all of which was in the form of short-term borrowings subject to daily changes in the bank's base rate or LIBOR. The Company's earnings would be affected by changes in these short-term interest rates. With the Company's borrowings at September 26, 2015, a one percent increase in short-term rates would reduce annual pretax earnings by \$462,000. The Company had no interest rate derivatives in place at September 26, 2015.

None of the Company's cash and cash equivalents at September 26, 2015 was invested in money market mutual funds, which are subject to the effects of market fluctuations in interest rates. The Company's portfolio of marketable securities is subject to customary equity market risk.

Although the Company conducts business in foreign countries, international operations are not material to its consolidated financial position, results of operations or cash flows. Additionally, foreign currency transaction gains and losses were not material to the Company's results of operations for the nine months ended September 26, 2015. Accordingly, the Company is not currently subject to material foreign currency exchange rate risks from the effects that exchange rate movements of foreign currencies would have on its future costs or on future cash flows it would receive from its foreign activity. To date, the Company has not entered into any foreign currency forward exchange contracts or other derivative financial instruments to hedge the effects of adverse fluctuations in foreign currency exchange rates.

ITEM 4: Controls and Procedures

As of the end of the period covered by this report, the Company conducted an evaluation, under the supervision and with the participation of the principal executive officer and principal financial officer, of its disclosure controls and procedures as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the Exchange Act). Based upon, and as of the date of that evaluation, the principal executive officer and principal financial officer concluded that the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure. There was no change in the Company's internal control over financial reporting during its most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, its internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1: Legal Proceedings

We are not a party to any material litigation and are not aware of any threatened litigation that would have a material adverse effect on our business.

ITEM 1A: Risk Factors

In addition to the other information set forth in this report, including the important information in **Forward-Looking Statements**, you should carefully consider the **Risk Factors** discussed in the Company's Annual Report on Form 10-K for the year ended December 27, 2014. If any of those factors were to occur, they could materially adversely affect the Company's financial condition or future results, and could cause its actual results to differ materially from those expressed in its forward-looking statements in this report. The Company is aware of no material changes to the Risk Factors discussed in the Company's Annual Report on Form 10-K for the year ended December 27, 2014, other than the following:

We incurred increased indebtedness in connection with the purchase of shares in the Tender Offer (see Note 8 **Shareholders' Equity (Deficit)** and Note 9 **Debt**) and, as a result, are more leveraged. We expect to generate the cash necessary to pay our expenses, finance our leasing business and to pay the principal and interest on all of our outstanding debt from cash flows provided by operating activities and by opportunistically using other means to repay or refinance our obligations as we determine appropriate. Our ability to pay our expenses, finance our leasing business and meet our debt service obligations depends on our future performance, which may be affected by financial, business, economic, and other factors including the risk factors described under Item 1A of our Form 10-K for the fiscal year ended December 27, 2014. If we do not have enough money to pay our debt service obligations, we may be required to refinance all or part of our existing debt, sell assets, borrow more money or raise equity. In such an event, we may not be able to refinance our debt, sell assets, borrow more money or raise equity on terms acceptable to us or at all. Also, our ability to carry out any of these activities on favorable terms, if at all, may be further impacted by any financial or credit crisis which may limit access to the credit markets and increase our cost of capital.

Table of Contents**ITEM 2: Unregistered Sales of Equity Securities and Use of Proceeds****Purchase of Equity Securities by the Issuer and Affiliated Purchasers**

The following table summarized the Company's common stock repurchase during the third quarter of 2015. No shares were purchased during the quarter.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of a Publicly Announced Plan(1)	Maximum Number of Shares that may yet be Purchased Under the Plan
June 28, 2015 to August 1, 2015		\$		166,700
August 2, 2015 to August 29, 2015		\$		166,700
August 30, 2015 to September 26, 2015		\$		166,700

(1) The Board of Directors' authorization for the repurchase of shares of the Company's common stock was originally approved in 1995 with no expiration date. The total shares approved for repurchase has been increased by additional Board of Directors' approvals and is currently limited to 5,000,000 shares, of which 166,700 may still be repurchased.

ITEM 3: Defaults Upon Senior Securities

None.

ITEM 4: Mine Safety Disclosures

Not applicable.

ITEM 5: Other Information

All information required to be reported in a report on Form 8-K during the period covered by this Form 10-Q has been reported.

Table of Contents

ITEM 6: Exhibits

- 3.1 Articles of Incorporation, as amended (Exhibit 3.1)(1)
- 3.2 By-laws, as amended and restated to date (Exhibit 3.2)(2)
- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
- 32.1 Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
- 32.2 Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
- 101 Interactive Data Files Pursuant to Rule 405 of Regulation S-T: Financial statements from the quarterly report on Form 10-Q of Winmark Corporation and Subsidiaries for the quarter ended September 26, 2015, formatted in XBRL: (i) Consolidated Condensed Balance Sheets, (ii) Consolidated Condensed Statements of Operations, (iii) Consolidated Condensed Statements of Comprehensive Income, (iv) Consolidated Condensed Statements of Cash Flows, and (v) Notes to Consolidated Condensed Financial Statements.

*Filed Herewith

(1) Incorporated by reference to the specified exhibit to the Registration Statement on Form S-1, effective August 24, 1993 (Reg. No. 333-65108).

(2) Incorporated by reference to the specified exhibit to the Annual Report on Form 10-K for the fiscal year ended December 30, 2006.

Table of Contents

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.

WINMARK CORPORATION

Date: October 21, 2015

By: /s/ John L. Morgan
John L. Morgan
Chairman of the Board and Chief Executive Officer
(principal executive officer)

Date: October 21, 2015

By: /s/ Anthony D. Ishaug
Anthony D. Ishaug
Chief Financial Officer and Treasurer
(principal financial and accounting officer)

Table of Contents

EXHIBIT INDEX

WINMARK CORPORATION

FORM 10-Q FOR QUARTER ENDED SEPTEMBER 26, 2015

Exhibit No.	Description
3.1	Articles of Incorporation, as amended (Exhibit 3.1)(1)
3.2	By-laws, as amended and restated to date (Exhibit 3.2)(2)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
32.1	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
32.2	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
101	Interactive Data Files Pursuant to Rule 405 of Regulation S-T: Financial statements from the quarterly report on Form 10-Q of Winmark Corporation and Subsidiaries for the quarter ended September 26, 2015, formatted in XBRL: (i) Consolidated Condensed Balance Sheets, (ii) Consolidated Condensed Statements of Operations, (iii) Consolidated Condensed Statements of Comprehensive Income, (iv) Consolidated Condensed Statements of Cash Flows, and (v) Notes to Consolidated Condensed Financial Statements.

*Filed Herewith

(1) Incorporated by reference to the specified exhibit to the Registration Statement on Form S-1, effective August 24, 1993 (Reg. No. 333-65108).

(2) Incorporated by reference to the specified exhibit to the Annual Report on Form 10-K for the fiscal year ended December 30, 2006.