WINMARK CORP
Form 10-Q
July 24, 2013
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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 June 29, 2013**

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

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, 5,044,484 shares outstanding as of July 17, 2013.

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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)

| | | June 29, 2013 | | December 29, 2012 |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Current Assets: | | | | |
| Cash and cash equivalents | $ | 2,041,300 | $ | 2,233,400 |
| Marketable securities | | 84,500 | | 85,900 |
| Receivables, less allowance for doubtful accounts of $15,200 and $17,300 | | 1,230,400 | | 1,237,100 |
| Net investment in leases - current | | 16,149,700 | | 13,461,200 |
| Income tax receivable | | 856,800 | | 1,400,700 |
| Inventories | | 76,800 | | 71,200 |
| Prepaid expenses | | 388,800 | | 445,200 |
| Total current assets | | 20,828,300 | | 18,934,700 |
| Net investment in leases - long-term | | 21,043,900 | | 22,697,100 |
| Long-term investments (See Note 4) | | | | |
| Property and equipment, net | | 1,166,000 | | 1,229,500 |
| Other assets | | 677,500 | | 677,500 |
| | $ | 43,715,700 | $ | 43,538,800 |
| **LIABILITIES AND SHAREHOLDERS EQUITY** | | | | |
| Current Liabilities: | | | | |
| Line of credit | $ | 2,000,000 | $ | 10,800,000 |
| Accounts payable | | 1,258,600 | | 2,203,700 |
| Accrued liabilities | | 1,983,800 | | 1,286,300 |
| Discounted lease rentals | | 906,400 | | 896,800 |
| Rents received in advance | | 62,000 | | 134,800 |
| Deferred revenue | | 1,569,700 | | 1,641,700 |
| Deferred income taxes | | 3,555,600 | | 3,549,900 |
| Total current liabilities | | 11,336,100 | | 20,513,200 |
| Long-Term Liabilities: | | | | |
| Discounted lease rentals | | 445,200 | | 177,900 |
| Rents received in advance | | 119,700 | | 117,700 |
| Deferred revenue | | 956,100 | | 953,000 |
| Other liabilities | | 1,184,600 | | 1,254,700 |
| Deferred income taxes | | 2,659,600 | | 2,594,300 |
| Total long-term liabilities | | 5,365,200 | | 5,097,600 |
| Shareholders Equity: | | | | |
| Common stock, no par value, 10,000,000 shares authorized, 5,044,484 and 4,996,459 shares issued and outstanding | | 1,142,900 | | |
| Accumulated other comprehensive loss | | (4,900) | | (4,000) |
| Retained earnings | | 25,876,400 | | 17,932,000 |
| Total shareholders equity | | 27,014,400 | | 17,928,000 |
| | $ | 43,715,700 | $ | 43,538,800 |

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 | | Six Months Ended | |
|---|---|---|---|---|
| | **June 29, 2013** | **June 30, 2012** | **June 29, 2013** | **June 30, 2012** |
| REVENUE: | | | | |
| Royalties | $ 8,608,200 | $ 7,693,900 | $ 17,083,100 | $ 15,982,400 |
| Leasing income | 4,130,200 | 3,285,000 | 7,538,000 | 5,677,100 |
| Merchandise sales | 557,400 | 656,800 | 1,223,100 | 1,366,600 |
| Franchise fees | 389,600 | 270,000 | 804,200 | 555,000 |
| Other | 338,100 | 286,700 | 523,500 | 444,700 |
| Total revenue | 14,023,500 | 12,192,400 | 27,171,900 | 24,025,800 |
| COST OF MERCHANDISE SOLD | 524,400 | 633,500 | 1,165,500 | 1,297,800 |
| LEASING EXPENSE | 610,500 | 325,700 | 890,200 | 565,500 |
| PROVISION FOR CREDIT LOSSES | (51,700) | (14,900) | (37,900) | (67,900) |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES | 5,879,100 | 5,221,600 | 11,417,000 | 10,357,700 |
| Income from operations | 7,061,200 | 6,026,500 | 13,737,100 | 11,872,700 |
| LOSS FROM EQUITY INVESTMENTS | | (240,700) | | (278,100) |
| INTEREST EXPENSE | (55,100) | (122,300) | (144,600) | (192,100) |
| INTEREST AND OTHER INCOME (EXPENSE) | (100) | (10,000) | (10,300) | 36,300 |
| Income before income taxes | 7,006,000 | 5,653,500 | 13,582,200 | 11,438,800 |
| PROVISION FOR INCOME TAXES | (2,669,100) | (2,249,100) | (5,187,800) | (4,518,400) |
| NET INCOME | $ 4,336,900 | $ 3,404,400 | $ 8,394,400 | $ 6,920,400 |
| EARNINGS PER SHARE BASIC | $ .86 | $ .67 | $ 1.68 | $ 1.37 |
| EARNINGS PER SHARE DILUTED | $ .83 | $ .65 | $ 1.61 | $ 1.31 |
| WEIGHTED AVERAGE SHARES OUTSTANDING BASIC | 5,024,284 | 5,056,289 | 5,010,803 | 5,054,620 |
| WEIGHTED AVERAGE SHARES OUTSTANDING DILUTED | 5,200,592 | 5,268,245 | 5,201,644 | 5,274,223 |

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 June 29, 2013 | Three Months Ended June 30, 2012 | Six Months Ended June 29, 2013 | Six Months Ended June 30, 2012 |
|---|---|---|---|---|
| NET INCOME | $ 4,336,900 | $ 3,404,400 | $ 8,394,400 | $ 6,920,400 |
| OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX: | | | | |
| Unrealized net gains (losses) on marketable securities: | | | | |
| Unrealized holding net gains (losses) arising during period | (4,800) | 3,600 | (1,400) | 3,600 |
| Reclassification adjustment for net gains included in net income | | | | (28,000) |
| OTHER COMPREHENSIVE INCOME (LOSS), BEFORE TAX | (4,800) | 3,600 | (1,400) | (24,400) |
| 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 | 1,800 | (1,400) | 500 | (1,400) |
| Reclassification adjustment for net gains included in net income | | | | 11,000 |
| INCOME TAX (EXPENSE) BENEFIT RELATED TO ITEMS OF OTHER COMPREHENSIVE INCOME | 1,800 | (1,400) | 500 | 9,600 |
| OTHER COMPREHENSIVE GAIN (LOSS), NET OF TAX | (3,000) | 2,200 | (900) | (14,800) |
| COMPREHENSIVE INCOME | $ 4,333,900 | $ 3,406,600 | $ 8,393,500 | $ 6,905,600 |

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)

| | Six Months Ended | |
|---|---|---|
| | **June 29, 2013** | **June 30, 2012** |
| OPERATING ACTIVITIES: | | |
| Net income | $ 8,394,400 | $ 6,920,400 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation | 212,000 | 219,400 |
| Provision for credit losses | (37,900) | (67,900) |
| Compensation expense related to stock options | 549,100 | 437,400 |
| Deferred income taxes | 71,000 | 275,100 |
| Gain on sale of marketable securities | | (30,000) |
| Loss from equity investments | | 278,100 |
| Deferred initial direct costs | (319,500) | (414,200) |
| Amortization of deferred initial direct costs | 284,000 | 273,100 |
| Tax benefits on exercised stock options | (261,800) | (327,400) |
| Change in operating assets and liabilities: | | |
| Receivables | 6,700 | 274,300 |
| Income tax receivable / payable | 806,200 | (717,500) |
| Inventories | (5,600) | (16,100) |
| Prepaid expenses | 56,400 | (39,100) |
| Accounts payable | (945,100) | (208,000) |
| Accrued and other liabilities | 627,400 | 803,800 |
| Rents received in advance and security deposits | 308,200 | 167,500 |
| Deferred revenue | (68,900) | 461,700 |
| Net cash provided by operating activities | 9,676,600 | 8,290,600 |
| INVESTING ACTIVITIES: | | |
| Proceeds from sale of marketable securities | | 1,313,500 |
| Purchase of marketable securities | | (380,700) |
| Purchase of property and equipment | (148,500) | (68,100) |
| Purchase of equipment for lease contracts | (10,194,500) | (10,913,900) |
| Principal collections on lease receivables | 8,501,100 | 8,566,100 |
| Net cash used for investing activities | (1,841,900) | (1,483,100) |
| FINANCING ACTIVITIES: | | |
| Proceeds from borrowings on line of credit | 2,000,000 | 17,600,000 |
| Payments on line of credit | (10,800,000) | (4,800,000) |
| Repurchases of common stock | (771,500) | (2,574,700) |
| Proceeds from exercises of stock options | 1,103,500 | 403,200 |
| Dividends paid | (450,000) | (25,722,100) |
| Proceeds from discounted lease rentals | 629,400 | 975,900 |
| Tax benefits on exercised stock options | 261,800 | 327,400 |
| Net cash used for financing activities | (8,026,800) | (13,790,300) |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (192,100) | (6,982,800) |
| Cash and cash equivalents, beginning of period | 2,233,400 | 9,020,100 |
| Cash and cash equivalents, end of period | $ 2,041,300 | $ 2,037,300 |
| SUPPLEMENTAL DISCLOSURES: | | |
| Cash paid for interest | $ 173,400 | $ 161,600 |
| Cash paid for income taxes | $ 4,310,700 | $ 5,024,300 |

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 six months ended June 29, 2013 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®, Play It Again Sports®, Once Upon A Child®, 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.

- 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.

The Company determined the fair value of its investment in Tomsten, Inc. to be zero based on Level 3 inputs using a discounted cash flow model which included inputs on future revenues, expenses and other cash flows. See Note 4.

Due to their nature, the carrying value of cash equivalents, receivables, long-term note investments, 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:

| | June 29, 2013 | | December 29, 2012 | |
|---|---|---|---|---|
| | Cost | Fair Value | Cost | Fair Value |
| Equity securities | $ 92,400 | $ 84,500 | $ 92,400 | $ 85,900 |

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

| | June 29, 2013 | December 29, 2012 |
|---|---|---|
| Unrealized gains | $ | $ |
| Unrealized losses | (7,900) | (6,500) |
| Net unrealized losses | $ (7,900) | $ (6,500) |

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

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | June 29, 2013 | June 30, 2012 | June 29, 2013 | June 30, 2012 |
| Realized gains | $ | $ | $ | $ 42,300 |
| Realized losses | | | | (12,300) |
| Net realized gains/(losses) | $ | $ | $ | $ 30,000 |

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.

***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, with such investment representing 22.0% of Tomsten s outstanding common stock. The Company applies the equity method of accounting to this investment, and during the first six months of 2012, the Company recorded

$278,100 for its pro-rata share of Tomsten s losses in the Consolidated Condensed Statements of Operations on the line item captioned Loss from Equity Investments. During the fourth quarter of 2012, the Company recorded an impairment charge for the remaining portion of its investment in Tomsten. On April 29, 2013, Tomsten filed a voluntary petition for reorganization under Chapter 11 of the United States Bankruptcy Code in Minnesota. The Company s carrying value of this investment was $0 as of June 29, 2013 and December 29, 2012.

The Company has a $2.0 million investment in senior subordinated promissory notes in BridgeFunds Limited ( BridgeFunds ). The Company has deemed this investment to be impaired, and as of December 29, 2012, the Company had recorded impairment charges and established a corresponding valuation allowance that reduced the net investment balance to $0. The Company has maintained the net investment balance of $0 as of June 29, 2013, as it does not expect to receive any cash flows from this investment.

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**5. Investment in Leasing Operations:**

Investment in leasing operations consists of the following:

| | June 29, 2013 | December 29, 2012 |
|---|---|---|
| Direct financing and sales-type leases: | | |
| Minimum lease payments receivable | $ 38,876,500 | $ 33,094,100 |
| Estimated residual value of equipment | 4,227,900 | 2,925,900 |
| Unearned lease income net of initial direct costs deferred | (5,943,300) | (5,155,400) |
| Security deposits | (3,261,500) | (2,882,400) |
| Equipment installed on leases not yet commenced | 3,828,000 | 8,443,600 |
| Total investment in direct financing and sales-type leases | 37,727,600 | 36,425,800 |
| Allowance for credit losses | (823,200) | (775,800) |
| Net investment in direct financing and sales-type leases | 36,904,400 | 35,650,000 |
| | | |
| Operating leases: | | |
| Operating lease assets | 1,267,700 | 1,564,300 |
| Less accumulated depreciation and amortization | (978,500) | (1,056,000) |
| Net investment in operating leases | 289, 200 | 508,300 |
| | | |
| Total net investment in leasing operations | $ 37,193,600 | $ 36,158,300 |

As of June 29, 2013, the $37.2 million total net investment in leases consists of $16.2 million classified as current and $21.0 million classified as long-term. As of December 29, 2012, the $36.2 million total net investment in leases consists of $13.5 million classified as current and $22.7 million classified as long-term.

As of June 29, 2013, no customer had leased assets totaling more than 10% 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 2013 and the full fiscal years thereafter as of June 29, 2013:

| | Direct Financing and Sales-Type Leases | | Operating Leases |
|---|---|---|---|
| | Minimum Lease Payments Receivable | Income Amortization | Minimum Lease Payments Receivable |
| 2013 | $ 11,448,000 | $ 2,816,500 | $ 715,200 |
| 2014 | 17,751,900 | 2,532,000 | 332,000 |
| 2015 | 8,368,400 | 574,300 | 49,900 |
| 2016 | 1,306,300 | 20,400 | |
| 2017 | 1,900 | 100 | |
| Thereafter | | | |
| | $ 38,876,500 | $ 5,943,300 | $ 1,097,100 |

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The activity in the allowance for credit losses for leasing operations during the first six months of 2013 and 2012, respectively, is as follows:

| | June 29, 2013 | June 30, 2012 |
|---|---|---|
| Balance at beginning of period | $ 775,800 | $ 803,800 |
| Provisions charged to expense | (37,900) | (67,900) |
| Recoveries | 102,600 | 159,900 |
| Deductions for amounts written-off | (17,300) | (110,000) |
| Balance at end of period | $ 823,200 | $ 785,800 |

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:

| | June 29, 2013 | | December 29, 2012 | |
|---|---|---|---|---|
| | Investment In Leases | Allowance for Credit Losses | Investment In Leases | Allowance for Credit Losses |
| Collectively evaluated for loss potential | $ 37,727,600 | $ 823,200 | $ 36,425,800 | $ 775,800 |
| Individually evaluated for loss potential | | | | |
| Total | $ 37,727,600 | $ 823,200 | $ 36,425,800 | $ 775,800 |

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-accrual. 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.

| | June 29, 2013 | | | | |
|---|---|---|---|---|---|
| | 0-60 Days Delinquent and Accruing | 61-90 Days Delinquent and Accruing | Over 90 Days Delinquent and Accruing | Non-Accrual | Total |
| Middle-Market | $ 36,461,700 | $ | $ | $ | $ 36,461,700 |
| Small-Ticket | 1,265,900 | | | | 1,265,900 |
| Total Investment in Leases | $ 37,727,600 | $ | $ | $ | $ 37,727,600 |

| | December 29, 2012 | | | | |
|---|---|---|---|---|---|
| | 0-60 Days Delinquent and Accruing | 61-90 Days Delinquent and Accruing | Over 90 Days Delinquent and Accruing | Non-Accrual | Total |
| Middle-Market | $ 34,901,300 | $ | $ | $ | $ 34,901,300 |
| Small-Ticket | 1,517,700 | | | 6,800 | 1,524,500 |
| Total Investment in Leases | $ 36,419,000 | $ | $ | $ 6,800 | $ 36,425,800 |

**6. New Accounting Pronouncements:**

In February 2013, the Financial Accounting Standards Board issued guidance that requires an entity to present, either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income/loss based on its source and the income statement line items affected by the reclassification. If a component is not required to be reclassified to net income in its entirety, entities would instead cross reference to the related footnote for additional information. This guidance is effective prospectively for reporting periods beginning after December 15, 2012. The Company adopted the new guidance on December 30, 2012 and such adoption has not impacted the consolidated results of the Company.

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**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 | | Six Months Ended | |
|---|---|---|---|---|
| | **June 29, 2013** | **June 30, 2012** | **June 29, 2013** | **June 30, 2012** |
| Denominator for basic EPS weighted average common shares | 5,024,284 | 5,056,289 | 5,010,803 | 5,054,620 |
| Dilutive shares associated with option plans | 176,308 | 211,956 | 190,841 | 219,603 |
| Denominator for diluted EPS weighted average common shares and dilutive potential common shares | 5,200,592 | 5,268,245 | 5,201,644 | 5,274,223 |
| | | | | |
| Options excluded from EPS calculation anti-dilutive | 17,474 | 25,554 | 18,451 | 17,110 |

**8. Shareholders Equity:**

***Dividends***

On January 23, 2013, the Company s Board of Directors approved the payment of a $0.04 per share quarterly cash dividend to shareholders of record at the close of business on February 6, 2013, which was paid on March 1, 2013.

On April 24, 2013, the Company s Board of Directors approved the payment of a $0.05 per share quarterly cash dividend to shareholders of record at the close of business on May 8, 2013, which was paid on June 3, 2013.

***Repurchase of Common Stock***

In the first six months of 2013, the Company repurchased 13,288 shares of its common stock for an aggregate purchase price of $0.8 million or $58.06 per share. Under the Board of Directors authorization, as of June 29, 2013, the Company has the ability to repurchase an additional 347,864 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 250,000 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 ).

The Company also sponsors a Stock Option Plan for Nonemployee Directors (the Nonemployee Directors Plan ) and has reserved a total of 300,000 shares for issuance to directors of the Company who are not employees.

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Stock option activity under the 2001 Plan, 2010 Plan and Nonemployee Directors Plan (collectively, the Option Plans ) as of June 29, 2013 was as follows:

| | Number of Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (years) | Intrinsic Value |
|---|---|---|---|---|
| Outstanding at December 29, 2012 | 613,727 | $ 31.46 | 7.06 | $ 16,010,000 |
| Granted | 47,500 | 59.77 | | |
| Exercised | (61,851) | 18.37 | | |
| Forfeited | (6,565) | 42.20 | | |
| Outstanding at June 29, 2013 | 592,811 | $ 34.98 | 6.95 | $ 17,719,700 |
| | | | | |
| Exercisable at June 29, 2013 | 342,675 | $ 24.59 | 5.69 | $ 13,802,800 |

The fair value of options granted under the Option Plans during the first six months of 2013 and 2012 were estimated on the date of grant using the Black-Scholes option pricing model with the following weighted average assumptions and results:

| | Six Months Ended June 29, 2013 | Six Months Ended June 30, 2012 |
|---|---|---|
| Risk free interest interest rate | 1.30% | 0.88% |
| Expected life (years) | 6 | 6 |
| Expected volatility | 32.5% | 31.4% |
| Dividend yield | 1.90% | 2.06% |
| Option fair value | $ 15.84 | $ 12.95 |

During the six months ended June 29, 2013, option holders surrendered 538 shares of previously owned common stock as payment for option shares exercised as provided for by the Option Plans. All unexercised options at June 29, 2013 have an exercise price equal to the fair market value on the date of the grant.

Compensation expense of $549,100 and $437,400 relating to the vested portion of the fair value of stock options granted was expensed to Selling, General and Administrative Expenses in the first six months of 2013 and 2012, respectively. As of June 29, 2013, the Company had $2.8 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 2.7 years.

**9. Line of Credit:**

As of June 29, 2013, there were $2.0 million in borrowings outstanding under the Company s Line of Credit with The PrivateBank and Trust Company and BMO Harris Bank N.A., bearing interest at 3.75%.

The Line of Credit, which provides for an aggregate commitment of $35.0 million subject to certain borrowing base limitations, 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 June 29, 2013, the Company was in compliance with all of its financial covenants.

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**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 3.1% at June 29, 2013 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 long-term investments, 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 | Six Months En |
|---|---|---|