

WATSCO INC
Form 10-Q
July 28, 2017
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarterly Period Ended June 30, 2017**

or

**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 1-5581

I.R.S. Employer Identification Number 59-0778222

WATSCO, INC.
(a Florida Corporation)

2665 South Bayshore Drive, Suite 901

Miami, Florida 33133

Telephone: (305) 714-4100

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 website, 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
Non-accelerated filer

Accelerated filer
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The number of shares of each class of our common stock outstanding as of July 24, 2017 was (i) 30,380,993 shares of Common stock, \$0.50 par value per share, excluding 6,322,650 treasury shares, and (ii) 5,325,772 shares of Class B common stock, \$0.50 par value per share, excluding 48,263 treasury shares.

Table of Contents

WATSCO, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

TABLE OF CONTENTS

	Page No.
PART I.	
	FINANCIAL INFORMATION
Item 1.	<u>Condensed Consolidated Unaudited Financial Statements</u>
	<u>Condensed Consolidated Unaudited Statements of Income – Quarter and Six Months Ended June 30, 2017 and 2016</u>
	3
	<u>Condensed Consolidated Unaudited Statements of Comprehensive Income – Quarter and Six Months Ended June 30, 2017 and 2016</u>
	4
	<u>Condensed Consolidated Balance Sheets – June 30, 2017 (Unaudited) and December 31, 2016</u>
	5
	<u>Condensed Consolidated Unaudited Statements of Cash Flows – Six Months Ended June 30, 2017 and 2016</u>
	6
	<u>Notes to Condensed Consolidated Unaudited Financial Statements</u>
	7
Item 2.	<u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>
	14
Item 3.	<u>Quantitative and Qualitative Disclosures about Market Risk</u>
	20
Item 4.	<u>Controls and Procedures</u>
	20
PART II.	OTHER INFORMATION
Item 1.	<u>Legal Proceedings</u>
	20
Item 1A.	<u>Risk Factors</u>
	21
Item 6.	<u>Exhibits</u>
	21
<u>SIGNATURE</u>	22
<u>EXHIBITS</u>	

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS**

WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF INCOME

(In thousands, except per share data)

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2017	2016	2017	2016
Revenues	\$ 1,275,924	\$ 1,214,435	\$ 2,148,019	\$ 2,065,859
Cost of sales	965,646	922,574	1,619,185	1,561,551
Gross profit	310,278	291,861	528,834	504,308
Selling, general and administrative expenses	180,930	174,271	350,787	336,050
Operating income	129,348	117,590	178,047	168,258
Interest expense, net	1,647	1,054	2,902	2,040
Income before income taxes	127,701	116,536	175,145	166,218
Income taxes	36,854	35,112	50,530	50,620
Net income	90,847	81,424	124,615	115,598
Less: net income attributable to non-controlling interest	17,091	16,803	24,678	25,440
Net income attributable to Watsco, Inc.	\$ 73,756	\$ 64,621	\$ 99,937	\$ 90,158
Earnings per share for Common and Class B common stock:				
Basic	\$ 2.07	\$ 1.82	\$ 2.80	\$ 2.55
Diluted	\$ 2.07	\$ 1.82	\$ 2.80	\$ 2.54

See accompanying notes to condensed consolidated unaudited financial statements.

Table of Contents

WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Quarter Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	\$ 90,847	\$ 81,424	\$ 124,615	\$ 115,598
Other comprehensive income, net of tax				
Foreign currency translation adjustment	5,770	1,193	7,925	14,886
Unrealized gain (loss) on cash flow hedging instruments	222	(1,082)	(87)	(1,875)
Reclassification of (gain) loss on cash flow hedging instruments into earnings	(683)	1,176	(861)	398
Unrealized (loss) gain on available-for-sale securities	(5)	(18)	3	(9)
Other comprehensive income	5,304	1,269	6,980	13,400
Comprehensive income	96,151	82,693	131,595	128,998
Less: comprehensive income attributable to non-controlling interest	19,094	17,300	27,317	30,640
Comprehensive income attributable to Watsco, Inc.	\$ 77,057	\$ 65,393	\$ 104,278	\$ 98,358

See accompanying notes to condensed consolidated unaudited financial statements.

Table of Contents

WATSCO, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	June 30, 2017 (Unaudited)	December 31, 2016
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 51,034	\$ 56,010
Accounts receivable, net	613,193	475,974
Inventories	770,012	685,011
Other current assets	17,502	23,161
Total current assets	1,451,741	1,240,156
Property and equipment, net	92,255	90,502
Goodwill	381,223	379,737
Intangible assets, net	159,803	158,564
Other assets	69,396	5,690
	\$ 2,154,418	\$ 1,874,649
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of other long-term obligations	\$ 204	\$ 200
Short-term borrowings	1,676	
Accounts payable	286,390	185,482
Accrued expenses and other current liabilities	136,166	129,206
Total current liabilities	424,436	314,888
Long-term obligations:		
Borrowings under revolving credit agreement	379,300	235,294
Other long-term obligations, net of current portion	244	348
Total long-term obligations	379,544	235,642
Deferred income taxes and other liabilities	70,078	72,371
Commitments and contingencies		
Watsco, Inc. shareholders equity:		
Common stock, \$0.50 par value	18,351	18,341
Class B common stock, \$0.50 par value	2,683	2,610
Preferred stock, \$0.50 par value		

Edgar Filing: WATSCO INC - Form 10-Q

Paid-in capital	575,661	592,350
Accumulated other comprehensive loss, net of tax	(39,189)	(43,530)
Retained earnings	575,584	550,482
Treasury stock, at cost	(114,425)	(114,425)
Total Watsco, Inc. shareholders' equity	1,018,665	1,005,828
Non-controlling interest	261,695	245,920
Total shareholders' equity	1,280,360	1,251,748
	\$ 2,154,418	\$ 1,874,649

See accompanying notes to condensed consolidated unaudited financial statements.

Table of Contents

WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS

(In thousands)

	Six Months Ended June 30,	
	2017	2016
Cash flows from operating activities:		
Net income	\$ 124,615	\$ 115,598
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,934	10,043
Share-based compensation	6,264	5,474
Deferred income tax provision	2,739	2,261
Other, net	1,740	3,321
Changes in operating assets and liabilities:		
Accounts receivable	(134,952)	(153,702)
Inventories	(83,523)	(72,370)
Accounts payable and other liabilities	104,573	130,840
Other, net	(151)	468
Net cash provided by operating activities	32,239	41,933
Cash flows from investing activities:		
Investment in unconsolidated entity	(63,600)	
Capital expenditures	(10,312)	(5,618)
Proceeds from sale of property and equipment	75	624
Net cash used in investing activities	(73,837)	(4,994)
Cash flows from financing activities:		
Net proceeds under revolving credit agreement	144,006	22,025
Proceeds from non-controlling interest for investment in unconsolidated entity	12,720	
Net proceeds from issuances of common stock	1,912	2,842
Proceeds from short-term borrowings	1,676	793
Net repayments of other long-term obligations	(100)	(60)
Distributions to non-controlling interest	(6,799)	(7,114)
Purchase of additional ownership from non-controlling interest	(42,688)	
Dividends on Common and Class B common stock	(74,835)	(60,164)
Net cash provided by (used in) financing activities	35,892	(41,678)
Effect of foreign exchange rate changes on cash and cash equivalents	730	54
Net decrease in cash and cash equivalents	(4,976)	(4,685)

Cash and cash equivalents at beginning of period	56,010	35,229
Cash and cash equivalents at end of period	\$ 51,034	\$ 30,544

See accompanying notes to condensed consolidated unaudited financial statements.

Table of Contents

WATSCO, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

June 30, 2017

(In thousands, except share and per share data)

1. BASIS OF PRESENTATION

Basis of Consolidation

Watsco, Inc. (collectively with its subsidiaries, Watsco, we, us or our) was incorporated in Florida in 1956 and is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies (HVAC/R) in the HVAC/R distribution industry in North America. The accompanying June 30, 2017 interim condensed consolidated unaudited financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in the annual financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to those rules and regulations, but we believe the disclosures made are adequate to make the information presented not misleading. In the opinion of management, all adjustments, consisting of normal and recurring adjustments, necessary for a fair presentation have been included in the condensed consolidated unaudited financial statements included herein. These statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our 2016 Annual Report on Form 10-K.

The condensed consolidated unaudited financial statements contained in this report include the accounts of Watsco, all of its wholly owned subsidiaries and the accounts of three joint ventures with Carrier Corporation (Carrier), in each of which Watsco maintains a controlling interest. All significant intercompany balances and transactions have been eliminated in consolidation.

The results of operations for the quarter and six months ended June 30, 2017 are not necessarily indicative of the results to be expected for the year ending December 31, 2017. Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on weather patterns, primarily during the Summer and Winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the fourth quarter. Demand related to the new construction market is fairly consistent during the year, subject to weather and economic conditions, including their effect on the number of housing completions.

Equity Method Investments

Investments in which we have the ability to exercise significant influence, but do not control, are accounted for under the equity method of accounting and are included in other assets in our consolidated balance sheets. Under this method of accounting, our proportionate share of the net income or loss of the investee is included in our consolidated statements of income.

Reclassifications

Certain reclassifications of prior year amounts have been made to conform to the 2017 presentation. These reclassifications had no effect on net income or earnings per share as previously reported.

Use of Estimates

The preparation of condensed consolidated unaudited financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated unaudited financial statements and the reported amounts of revenues and expenses for the reporting period. Significant estimates include valuation reserves for accounts receivable, inventories and income taxes, reserves related to self-insurance programs and the valuation of goodwill and indefinite lived intangible assets. While we believe that these estimates are reasonable, actual results could differ from such estimates.

New Accounting Standards

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (the FASB) issued a standard on revenue recognition that provides a single, comprehensive revenue recognition model for all contracts with customers. The standard is principle-based and provides a five-step model to determine the measurement of revenue and timing of when it is recognized. This standard will be applied using either of the following transition methods: (i) a full retrospective approach reflecting the application of the standard in each prior reporting period with the option to elect certain practical expedients or (ii) a modified retrospective approach with the cumulative effect of initially adopting the standard recognized at the date of adoption, which requires additional footnote disclosures. This standard is effective for our interim and annual reporting periods beginning after December 15, 2017, with early adoption permitted

Table of Contents

for annual reporting periods beginning after December 15, 2016. We will adopt this guidance on January 1, 2018. While we are currently evaluating the method of adoption and the impact of the provisions of this standard, we expect similar performance obligations to result under this guidance as compared with deliverables and separate units of accounting currently identified. As a result, we expect the timing of our revenue recognition to generally remain the same.

Measurement of Inventory

In July 2015, the FASB issued guidance that simplifies the measurement of inventory by replacing the lower of cost or market test with a lower of cost and net realizable value test. The guidance applies to all inventory that is measured using first-in, first-out or average cost methods. This guidance must be applied prospectively and became effective for interim and annual reporting periods beginning after December 15, 2016. The adoption of this guidance did not have an impact on our consolidated financial statements.

Classification of Deferred Taxes

In November 2015, the FASB issued guidance that requires deferred tax assets and liabilities to be classified as noncurrent in a classified balance sheet. This guidance may be applied either prospectively or retrospectively and became effective for interim and annual reporting periods beginning after December 15, 2016. The adoption of this guidance on January 1, 2017 using the prospective approach did not have a material impact on our consolidated financial statements.

Leases

In February 2016, the FASB issued guidance on accounting for leases, which requires lessees to recognize most leases on their balance sheets for the rights and obligations created by those leases. The guidance requires