

WATSCO INC  
Form 10-Q  
November 01, 2013

**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 September 30, 2013**

**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

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

The number of shares of common stock outstanding as of October 28, 2013 was (i) 30,036,054 shares of Common stock, \$0.50 par value per share, excluding 6,322,650 treasury shares, and (ii) 4,685,473 shares of Class B common stock, \$0.50 par value per share, excluding 48,263 treasury shares.

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**WATSCO, INC. AND SUBSIDIARIES**

**QUARTERLY REPORT ON FORM 10-Q**

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**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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenues	<b>\$ 1,081,893</b>	\$ 1,020,859	<b>\$ 2,915,978</b>	\$ 2,666,172
Cost of sales	<b>823,296</b>	778,354	<b>2,215,255</b>	2,034,570
Gross profit	<b>258,597</b>	242,505	<b>700,723</b>	631,602
Selling, general and administrative expenses	<b>163,142</b>	156,808	<b>469,629</b>	440,125
Operating income	<b>95,455</b>	85,697	<b>231,094</b>	191,477
Interest expense, net	<b>1,781</b>	1,185	<b>4,651</b>	3,423
Income before income taxes	<b>93,674</b>	84,512	<b>226,443</b>	188,054
Income taxes	<b>27,556</b>	24,981	<b>66,654</b>	54,129
Net income	<b>66,118</b>	59,531	<b>159,789</b>	133,925
Less: net income attributable to noncontrolling interest	<b>20,419</b>	18,526	<b>49,387</b>	45,350
Net income attributable to Watsco, Inc.	<b>\$ 45,699</b>	\$ 41,005	<b>\$ 110,402</b>	\$ 88,575
Earnings per share for Common and Class B common stock:				
Basic	<b>\$ 1.32</b>	\$ 1.19	<b>\$ 3.19</b>	\$ 2.62
Diluted	<b>\$ 1.32</b>	\$ 1.19	<b>\$ 3.18</b>	\$ 2.61

*See accompanying notes to condensed consolidated unaudited financial statements.*

## WATSCO, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	<b>\$ 66,118</b>	\$ 59,531	<b>\$ 159,789</b>	\$ 133,925
Other comprehensive income (loss), net of tax				
Foreign currency translation adjustment	<b>5,073</b>	8,454	<b>(8,367)</b>	(212)
Unrealized gain on available-for-sale securities arising during the period	<b>18</b>	15	<b>15</b>	27
Other comprehensive income (loss)	<b>5,091</b>	8,469	<b>(8,352)</b>	(185)
Comprehensive income	<b>71,209</b>	68,000	<b>151,437</b>	133,740
Less: comprehensive income attributable to noncontrolling interest	<b>22,588</b>	22,249	<b>45,792</b>	45,247
Comprehensive income attributable to Watsco, Inc.	<b>\$ 48,621</b>	\$ 45,751	<b>\$ 105,645</b>	\$ 88,493

*See accompanying notes to condensed consolidated unaudited financial statements.*

WATSCO, INC. AND SUBSIDIARIES  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	September 30, 2013 (Unaudited)	December 31, 2012
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 29,229	\$ 73,770
Accounts receivable, net	466,340	377,655
Inventories	643,874	546,083
Other current assets	22,372	17,943
<b>Total current assets</b>	<b>1,161,815</b>	<b>1,015,451</b>
Property and equipment, net	44,891	42,842
Goodwill	394,746	397,262
Intangible assets, net	209,832	219,501
Other assets	6,749	6,999
	<b>\$ 1,818,033</b>	<b>\$ 1,682,055</b>
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Current liabilities:		
Current portion of other long-term obligations	\$ 106	\$ 4
Accounts payable	198,277	184,957
Accrued expenses and other current liabilities	113,406	97,397
<b>Total current liabilities</b>	<b>311,789</b>	<b>282,358</b>
Long-term obligations:		
Borrowings under revolving credit agreement	284,800	316,182
Other long-term obligations, net of current portion	540	14
<b>Total long-term obligations</b>	<b>285,340</b>	<b>316,196</b>
Deferred income taxes and other liabilities	64,381	61,461
Commitments and contingencies		
Watsco, Inc. shareholders equity:		
Common stock, \$0.50 par value	18,166	18,131
Class B common stock, \$0.50 par value	2,368	2,315
Preferred stock, \$0.50 par value		
Paid-in capital	603,586	592,820
Accumulated other comprehensive loss, net of tax	(6,859)	(2,102)
Retained earnings	335,919	251,475

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Treasury stock, at cost	(114,425)	(114,425)
Total Watsco, Inc. shareholders equity	838,755	748,214
Noncontrolling interest	317,768	273,826
Total shareholders equity	1,156,523	1,022,040
	\$ 1,818,033	\$ 1,682,055

*See accompanying notes to condensed consolidated unaudited financial statements.*

## WATSCO, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS

Nine Months Ended September 30, 2013 and 2012

(In thousands)

	2013	2012
Cash flows from operating activities:		
Net income	<b>\$ 159,789</b>	\$ 133,925
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	<b>13,223</b>	11,276
Share-based compensation	<b>6,453</b>	5,609
Deferred income tax provision	<b>4,208</b>	4,743
Excess tax benefits from share-based compensation	<b>(590)</b>	(913)
Other, net	<b>1,510</b>	2,347
Changes in operating assets and liabilities, net of effects of acquisition:		
Accounts receivable	<b>(90,205)</b>	(81,793)
Inventories	<b>(99,655)</b>	(98,001)
Accounts payable and other liabilities	<b>60,278</b>	87,696
Other, net	<b>(3,828)</b>	(446)
Net cash provided by operating activities	<b>51,183</b>	64,443
Cash flows from investing activities:		
Capital expenditures	<b>(10,915)</b>	(9,228)
Business acquisition, net of cash acquired		(80,479)
Proceeds from sale of property and equipment	<b>222</b>	405
Net cash used in investing activities	<b>(10,693)</b>	(89,302)
Cash flows from financing activities:		
Distributions to noncontrolling interest	<b>(31,487)</b>	(16,003)
Net (repayments) proceeds under current revolving credit agreement	<b>(30,010)</b>	202,271
Dividends on Common and Class B common stock	<b>(25,958)</b>	(62,379)
Payment of fees related to revolving credit agreement	<b>(456)</b>	(2,072)
Purchase of additional ownership from noncontrolling interest		(51,881)
Net repayments under prior revolving credit agreements		(20,000)
Excess tax benefits from share-based compensation	<b>590</b>	913
Net proceeds from other long-term obligations	<b>628</b>	2
Net proceeds from issuances of common stock	<b>1,998</b>	3,977
Net cash (used in) provided by financing activities	<b>(84,695)</b>	54,828
Effect of foreign exchange rate changes on cash and cash equivalents	<b>(336)</b>	319
Net (decrease) increase in cash and cash equivalents	<b>(44,541)</b>	30,288

Cash and cash equivalents at beginning of period	<b>73,770</b>	15,673
Cash and cash equivalents at end of period	<b>\$ 29,229</b>	\$ 45,961
<b>Supplemental cash flow information:</b>		
Common stock issued for Carrier Enterprise III		\$ 93,250
<i>See accompanying notes to condensed consolidated unaudited financial statements.</i>		

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WATSCO, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

September 30, 2013

(In thousands, except share and per share data)

## 1. BASIS OF PRESENTATION

### Basis of Consolidation

Watsco, Inc. and its subsidiaries (collectively, *Watsco*, which may be referred to as *we*, *us* or *our*) was incorporated in 1956 in Florida 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. The accompanying Watsco September 30, 2013 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, although 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 herein. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2012.

The condensed consolidated unaudited financial statements contained in this report include the accounts of Watsco and all of its wholly owned subsidiaries and include 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.

The results of operations for the quarter and nine months ended September 30, 2013 are not necessarily indicative of the results to be expected for the year ending December 31, 2013. 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 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 sectors throughout most of the markets is fairly consistent during the year, except for dependence on housing completions and related weather and economic conditions.

### Reclassifications

Certain reclassifications of prior year amounts have been made to conform to the 2013 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**

### *Reporting Amounts Reclassified Out of Accumulated Other Comprehensive Income*

In February 2013, the Financial Accounting Standards Board ( FASB ) amended guidance that requires disclosure for amounts reclassified out of accumulated other comprehensive income ( AOCI ) by component. The amendments require the presentation of amounts reclassified out of AOCI by the respective line items of net income if the amount reclassified is required to be reclassified to net income in its entirety in the reporting period. For amounts that are not required to be reclassified in their entirety to net income, a cross-reference to other disclosures that provide additional detail about those amounts is required. This guidance is effective prospectively for interim and annual reporting periods beginning after December 15, 2012. The adoption of this guidance did not have an impact on our condensed consolidated unaudited financial statements.

### *Presentation of Unrecognized Tax Benefits*

In July 2013, the FASB issued guidance that requires the presentation of an unrecognized tax benefit as a reduction to a deferred tax asset for a net operating loss carryforward rather than as a liability when the uncertain tax position would reduce the net operating loss under the tax law of the applicable jurisdiction and the entity intends to use the deferred tax asset for that purpose. This guidance is effective prospectively for interim and annual reporting periods beginning after December 15, 2013. We do not expect the adoption of this guidance to have a material impact on our condensed consolidated unaudited financial statements.

**2. EARNINGS PER SHARE**

The following table presents the calculation of basic and diluted earnings per common share for our Common and Class B common stock:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Basic Earnings per Share:</b>				
Net income attributable to Watsco, Inc. shareholders	\$ 45,699	\$ 41,005	\$ 110,402	\$ 88,575
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	3,251	2,822	7,813	6,119
Earnings allocated to Watsco, Inc. shareholders	\$ 42,448	\$ 38,183	\$ 102,589	\$ 82,456
Weighted-average Common and Class B common shares outstanding for basic earnings per share	32,206,448	32,107,701	32,182,430	31,529,296
Basic earnings per share for Common and Class B common stock	\$ 1.32	\$ 1.19	\$ 3.19	\$ 2.62
Allocation of earnings for Basic:				
Common stock	\$ 38,880	\$ 34,789	\$ 93,960	\$ 74,992
Class B common stock	3,568	3,394	8,629	7,464
	\$ 42,448	\$ 38,183	\$ 102,589	\$ 82,456
<b>Diluted Earnings per Share:</b>				
Net income attributable to Watsco, Inc. shareholders	\$ 45,699	\$ 41,005	\$ 110,402	\$ 88,575
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	3,246	2,820	7,801	6,115
Earnings allocated to Watsco, Inc. shareholders	\$ 42,453	\$ 38,185	\$ 102,601	\$ 82,460
Weighted-average Common and Class B common shares outstanding for basic earnings per share	32,206,448	32,107,701	32,182,430	31,529,296
Effect of dilutive stock options	69,665	60,465	63,936	68,242
Weighted-average Common and Class B common shares outstanding for diluted earnings per share	32,276,113	32,168,166	32,246,366	31,597,538

Diluted earnings per share for Common and Class B common stock	\$	<b>1.32</b>	\$	1.19	\$	<b>3.18</b>	\$	2.61
Anti-dilutive stock options not included in above		<b>620</b>		2,283		<b>4,963</b>		11,445

Diluted earnings per share for our Common stock assumes the conversion of all of our Class B common stock into Common stock as of the beginning of the fiscal year and adjusts for the dilutive effects of outstanding stock options using the treasury stock method; therefore, no allocation of earnings to Class B common stock is required. As of September 30, 2013 and 2012, our outstanding Class B common stock was convertible into 2,706,860 and 2,854,055 shares of our Common stock, respectively.

**3. OTHER COMPREHENSIVE INCOME (LOSS)**

Other comprehensive income (loss) consists of the foreign currency translation adjustment associated with our Canadian operations use of the Canadian dollar as their functional currency and changes in the unrealized gain on available-for-sale securities. The tax effects allocated to each component of other comprehensive income (loss) are as follows:

	Quarter Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Foreign currency translation adjustment	\$ 5,073	\$ 8,454	\$ (8,367)	\$ (212)
Unrealized gain on available-for-sale securities	\$ 27	\$ 28	\$ 24	\$ 51
Income tax expense	(9)	(13)	(9)	(24)
Unrealized gain on available-for-sale securities, net of tax	\$ 18	\$ 15	\$ 15	\$ 27
Other comprehensive income (loss)	\$ 5,091	\$ 8,469	\$ (8,352)	\$ (185)

The changes in accumulated other comprehensive loss, net of tax, are as follows:

<i>Nine Months Ended September 30,</i>	2013	2012
Foreign currency translation adjustment:		
Beginning balance	\$ (1,785)	\$
Current period other comprehensive loss	(4,772)	(109)
Ending balance	\$ (6,557)	\$ (109)
Available-for-sale securities:		
Beginning balance	\$ (317)	\$ (352)
Current period other comprehensive income	15	27
Ending balance	\$ (302)	\$ (325)
Accumulated other comprehensive loss, net of tax	\$ (6,859)	\$ (434)

**4. DERIVATIVE FINANCIAL INSTRUMENTS**

We routinely use certain derivative instruments to hedge foreign currency exposure. Although these derivatives were not designated as hedges and/or did not qualify for hedge accounting, they were effective economic hedges for the periods presented. The changes in fair value of economic hedges are recognized in earnings. During 2012, we entered into foreign currency forward contracts to offset the earnings impact that foreign currency exchange rate fluctuations would otherwise have had on certain monetary liabilities that are denominated in nonfunctional currencies. The changes in fair value of these foreign currency forward contracts were a (loss) gain of \$(1,534), \$14, \$(6) and \$(233) for the quarters and nine months ended September 30, 2013 and 2012, respectively, and are included in selling, general and administrative expenses in our condensed consolidated unaudited statements of income. The total notional value of our foreign currency exchange contracts as of September 30, 2013 was \$40,500, and such contracts have

varying terms expiring through January 2014. See Note 5.

## 5. FAIR VALUE MEASUREMENTS

The following tables present our assets and liabilities carried at fair value that are measured on a recurring basis:

Description	Fair Value at September 30, 2013	Fair Value Measurements at September 30, 2013 Using		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Available-for-sale securities	\$ 250	\$ 250		
<b>Liabilities:</b>				
Derivative financial instruments	\$ 203		\$ 203	

Description	Fair Value	Fair Value Measurements		
	at December 31, 2012	at December 31, 2012 Using		
		Level 1	Level 2	Level 3
<b>Assets:</b>				
Available-for-sale securities	\$ 226	\$ 226		
<b>Liabilities:</b>				
Derivative financial instruments	\$ 197		\$ 197	

The following is a description of the valuation techniques used for these assets and liabilities, as well as the level of input used to measure fair value:

*Available-for-sale securities* the investments are exchange-traded equity securities. Fair values for these investments are based on closing stock prices from active markets and are therefore classified within Level 1 of the fair value hierarchy. The fair value of available-for-sale securities is included in other assets in our condensed consolidated balance sheets.

*Derivative financial instruments* the derivatives are foreign currency forward contracts. Fair value is based on observable market inputs, such as forward rates in active markets; therefore, we classify the derivatives within Level 2 of the valuation hierarchy. The fair value of derivative financial instruments is included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

There were no transfers in or out of Level 1 and Level 2 during the nine months ended September 30, 2013.

## 6. ACQUISITIONS

### Carrier Enterprise I

Carrier Enterprise, LLC ( Carrier Enterprise I ) is a joint venture formed on July 1, 2009 with Carrier that operates a network of locations primarily throughout the U.S. Sun Belt. From its inception until July 2, 2012, we owned 60% of the joint venture and Carrier owned 40%. We had an option to purchase an additional 10% ownership interest in Carrier Enterprise I, which became exercisable on July 1, 2012. On July 2, 2012, we exercised this option and acquired an additional 10% ownership interest in Carrier Enterprise I for cash consideration of \$51,881. We have a second option to purchase an additional 10% interest in Carrier Enterprise I, which becomes exercisable beginning on July 1, 2014.

### Carrier Enterprise II

In 2011, we formed a second joint venture with Carrier and completed two additional transactions. In April 2011, Carrier contributed 28 of its company-owned locations in eight Northeast U.S. states, and we contributed 14 locations in the Northeast U.S. In July 2011, we purchased Carrier's distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have a 60% controlling interest in Carrier Enterprise II, and Carrier has a 40% noncontrolling interest. Neither we nor Carrier has any options to purchase additional ownership interests in Carrier Enterprise II.

### Carrier Enterprise III

On April 27, 2012, we completed the formation of a joint venture with UTC Canada Corporation ( UTC Canada ), an affiliate of Carrier, to distribute Carrier-manufactured HVAC products in Canada. The newly formed joint venture, Carrier Enterprise Canada, L.P. ( Carrier Enterprise III ), operates 35 locations throughout Canada. We have a 60%

controlling interest in Carrier Enterprise III and Carrier has a 40% noncontrolling interest. Total consideration paid by us for our 60% controlling interest in Carrier Enterprise III comprised cash consideration of \$80,489 and the issuance to UTC Canada of 1,250,000 shares of Common stock, having a fair value of \$93,250. Neither we nor UTC Canada has any options to purchase additional ownership interests in Carrier Enterprise III.

The purchase price for Carrier Enterprise III resulted in the recognition of \$216,463 in goodwill and intangibles. The fair value of the identified intangible assets was \$151,172 and consisted of \$95,515 in trade names and distribution rights and \$55,657 in customer relationships to be amortized over a 15 year period. For Canadian income tax purposes, seventy-five percent of the tax basis of the acquired goodwill is amortized at a rate of 7% annually on a declining balance basis.

The purchase price allocation is based upon a purchase price of \$173,739, which represents the fair value of our 60% controlling interest in Carrier Enterprise III. The table below presents the allocation of the total consideration to tangible and intangible assets acquired, liabilities assumed and the noncontrolling interest from the acquisition of our 60% controlling interest in Carrier Enterprise III based on the respective fair values as of April 27, 2012:

Cash	\$ 10
Accounts receivable	46,718
Inventories	55,024
Other current assets	481
Property and equipment	2,517
Goodwill	65,291
Intangible assets	151,172
Other assets	978
Accounts payable and accrued expenses	(44,208)
Noncontrolling interest	(104,244)
<b>Total purchase price</b>	<b>\$ 173,739</b>

The fair value of the noncontrolling interest was determined by applying a pro-rata value of the total invested capital adjusted for a discount for lack of control that market participants would consider when estimating the fair value of the noncontrolling interest.

The unaudited pro forma financial information, combining our results of operations with the operations of Carrier Enterprise III as if the joint venture had been formed on January 1, 2012, is as follows:

	Nine Months Ended September 30, 2012
Revenues	\$ 2,761,081
Net income	133,052
Less: net income attributable to noncontrolling interest	45,236
Net income attributable to Watsco, Inc.	\$ 87,816
Diluted earnings per share for Common and Class B common stock	\$ 2.59

The foregoing unaudited pro forma financial information is presented for informational purposes only. The unaudited pro forma financial information for the periods presented includes adjustments to record income taxes related to our portion of Carrier Enterprise III's income, amortization related to identified intangible assets with finite lives and interest expense on borrowings incurred to acquire our 60% controlling interest. This unaudited pro forma financial information does not include adjustments to add or remove certain corporate expenses of Carrier Enterprise III, which may or may not be incurred in future periods, or adjustments for depreciation or synergies that may be realized subsequent to the acquisition date. This unaudited pro forma financial information does not necessarily reflect our future results of operations or what the results of operations would have been had we acquired our 60% controlling

interest in and operated Carrier Enterprise III as of the beginning of the periods presented.

## **7. DEBT**

On July 1, 2013, we entered into Amendment No. 2 to our unsecured \$500,000 syndicated revolving credit agreement, which extended the maturity date from April 27, 2017 to July 1, 2018, reduced pricing, improved covenant flexibility to reflect the seasonal nature of our working capital requirements and modified certain definitions. Borrowings under the amended credit facility bear interest at either LIBOR-based rates plus a spread, which ranges from 87.5 to 250 basis-points, depending upon our ratio of total debt to EBITDA, or on rates based on the higher of the Prime rate or the Federal Funds Rate, in each case plus a spread which ranges from 0 to 150 basis-points, depending upon our ratio of total debt to EBITDA. We pay a variable commitment fee on the unused portion of the commitment under the amended credit facility, ranging from 12.5 to 35 basis-points. At September 30, 2013 and December 31, 2012, \$284,800 and \$316,182 were outstanding under the revolving credit agreement, respectively. The revolving credit agreement contains customary affirmative and negative covenants including financial covenants with respect to consolidated leverage and interest coverage ratios and other customary restrictions. We believe we were in compliance with all covenants at September 30, 2013.

## **8. SHAREHOLDERS EQUITY**

### **Common Stock Dividends**

We paid cash dividends of \$0.25, \$0.62, \$0.75 and \$1.86 per share of Common stock and Class B common stock during the quarters and nine months ended September 30, 2013 and 2012, respectively.

### **Non-Vested (Restricted) Stock**

During the quarters ended September 30, 2013 and 2012, we granted 31,500 and 53,000 shares of non-vested (restricted) stock, respectively. During the nine months ended September 30, 2013 and 2012, we granted 119,043 and 111,301 shares of non-vested (restricted) stock, respectively.

## Stock Options

During the quarters ended September 30, 2013 and 2012, 34,700 and 18,250 stock options, respectively, were exercised for Common stock. During the nine months ended September 30, 2013 and 2012, 44,200 and 109,084 stock options, respectively, were exercised for Common stock. Cash received from Common stock issued as a result of stock options exercised during the quarters and nine months ended September 30, 2013 and 2012, was \$1,162, \$571, \$1,539 and \$3,380, respectively.

During both the quarter and nine months ended September 30, 2013, 5,448 shares of Class B Common stock with an aggregate fair market value of \$490 were delivered as payment in lieu of cash for stock option exercises and related tax withholdings. We retired these shares upon delivery. During the quarter and nine months ended September 30, 2012, 3,592 shares of Common stock with an aggregate fair market value of \$276 and 23,159 shares of Common stock with an aggregate fair market value of \$1,725, respectively, were withheld as payment in lieu of cash for stock option exercises and related tax withholdings.

## Employee Stock Purchase Plan

During the quarters ended September 30, 2013 and 2012, 1,944 and 3,126 shares of Common stock were issued under our employee stock purchase plan for which we received net proceeds of \$160 and \$217, respectively. During the nine months ended September 30, 2013 and 2012, 5,870 and 8,720 shares of Common stock were issued under our employee stock purchase plan for which we received net proceeds of \$459 and \$597, respectively.

## 401(k) Plan

During the nine months ended September 30, 2013 and 2012, we issued 22,551 and 26,991 shares of Common stock to our profit sharing retirement plan representing the Common stock discretionary matching contribution of \$1,689 and \$1,772, respectively.

## Noncontrolling Interest

We have a 60% controlling interest in both Carrier Enterprise II and Carrier Enterprise III, and Carrier has a 40% noncontrolling interest in each. Effective July 2, 2012, our controlling interest in Carrier Enterprise I increased to 70% from 60%, following our exercise of the option described in Note 6. The following table reconciles shareholders equity attributable to Carrier's noncontrolling interest:

Noncontrolling interest at December 31, 2012	\$ 273,826
Net income attributable to noncontrolling interest	49,387
Foreign currency translation adjustment	(3,595)
Distributions to noncontrolling interest	(1,850)
<b>Noncontrolling interest at September 30, 2013</b>	<b>\$ 317,768</b>

## 9. COMMITMENTS AND CONTINGENCIES

### Litigation, Claims and Assessments

We are involved in litigation incidental to the operation of our business. We vigorously defend all matters in which we or our subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments that may affect us. Although the adequacy of existing insurance coverage and the outcome of any legal proceedings cannot be predicted with certainty, based on the current information available, we do not believe the ultimate liability associated with any known claims or litigation will have a material adverse effect on our financial condition or results of operations.

### **Self-Insurance**

Self-insurance reserves are maintained relative to company-wide casualty insurance and health benefit programs. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverage. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occur and exceed these estimates, additional reserves may be required. The estimation process contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. Reserves in the amounts of \$5,478 and \$4,844 at September 30, 2013 and December 31, 2012, respectively, were established related to such insurance programs and are included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

## 10. RELATED PARTY TRANSACTIONS

Purchases from Carrier and its affiliates comprised 62%, 57%, 58% and 57% of all purchases made during the quarters and nine months ended September 30, 2013 and 2012, respectively. At September 30, 2013 and December 31, 2012, approximately \$96,000 and \$62,000, respectively, was payable to Carrier and its affiliates, net of receivables. Our joint ventures with Carrier also sell HVAC products to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statements of income for the quarters and nine months ended September 30, 2013 and 2012 include \$7,834, \$10,466, \$21,822 and \$27,314, respectively, of sales to Carrier and its affiliates. We believe these transactions are conducted at arm's-length in the ordinary course of business.

Carrier Enterprise II entered into Transactional Services Agreements (TSAs) with Carrier, pursuant to which Carrier performed certain business processes on its behalf, including processes involving the use of certain information technologies. The services provided by Carrier pursuant to the TSAs terminated on April 30, 2012. The fees related to these TSAs were \$807 for the nine months ended September 30, 2012 and are included in selling, general and administrative expenses in our condensed consolidated unaudited statements of income. At December 31, 2012, \$25 related to these TSAs was payable to Carrier and was included in accrued expenses and other current liabilities in our condensed consolidated balance sheet. Amounts outstanding were repaid in 2013 and no further services are required under the TSAs for Carrier Enterprise II.

Carrier Enterprise III entered into TSAs with UTC Canada, pursuant to which UTC Canada performs certain business processes on behalf of Carrier Enterprise III, including processes involving the use of certain information technologies, and UTC Canada entered into TSAs with Carrier Enterprise III, pursuant to which Carrier Enterprise III performs certain business processes on behalf of UTC Canada. The services provided pursuant to the TSAs terminate on various dates but may be extended as agreed upon by the parties. The fees payable by Carrier Enterprise III to UTC Canada under one TSA were substantially offset by the fees payable to Carrier Enterprise III by UTC Canada under the other TSA.

At December 31, 2012, \$29,637 was payable to Carrier and UTC Canada for unpaid distributions declared to the noncontrolling interest. This amount was paid to Carrier and UTC Canada in February 2013.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### Forward-Looking Statements

This Quarterly Report contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions and/or joint ventures, (iv) financing plans and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based largely on management's current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including, but not limited to:

general economic conditions;

competitive factors within the HVAC/R industry;

effects of supplier concentration;

fluctuations in certain commodity costs;

consumer spending;

consumer debt levels;

new housing starts and completions;

capital spending in the commercial construction market;

access to liquidity needed for operations;

seasonal nature of product sales;

weather conditions;

insurance coverage risks;

federal, state and local regulations impacting our industry and products;

prevailing interest rates;

foreign currency exchange rate fluctuations;

international political risk; and

the continued viability of our business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if realized, in whole or in part, that the information will have the expected consequences to, or effects on, our business or operations. For additional information identifying other important factors that may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, see our SEC filings, including but not limited to, the discussion included in Item 1A Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2012. Forward-looking statements speak only as of the date the statement was made. We assume no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as required by applicable law.

The following information should be read in conjunction with the condensed consolidated unaudited financial statements and notes thereto included under Item 1 of this Quarterly Report on Form 10-Q. In addition, reference should be made to our audited consolidated financial statements and notes thereto and the related Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2012.

### **Company Overview**

Watsco, Inc. and its subsidiaries (collectively, *Watsco*, or *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. At September 30, 2013, we operated from 571 locations in 38 U.S. states, Canada, Mexico and Puerto Rico with additional market coverage on an export basis to Latin America and the Caribbean.

Revenues primarily consist of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. Selling, general and administrative expenses primarily consist of selling expenses, the largest components of which are salaries, commissions and marketing expenses that are variable and correlate to changes in sales. Other significant selling, general and administrative expenses relate to the operation of warehouse facilities, including a fleet of trucks and forklifts and facility rent, which are payable mostly under non-cancelable operating leases.

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 during 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 usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly consistent during the year, except for dependence on housing completions and related weather and economic conditions.

### **Joint Ventures with Carrier Corporation**

In 2009, we formed a joint venture with Carrier Corporation ( *Carrier* ), which we refer to as Carrier Enterprise I, in which Carrier contributed 95 of its company-owned locations in 13 U.S. Sun Belt states and Puerto Rico and its export division in Miami, Florida, and we contributed 15 locations that distributed Carrier products. On July 2, 2012, we exercised our option to acquire an additional 10% ownership interest in Carrier Enterprise I, which increased our ownership interest to 70%. We have an option to purchase from Carrier an additional 10% interest in Carrier Enterprise I, which becomes exercisable in July 2014.

In 2011, we formed a second joint venture with Carrier and completed two additional transactions. In April 2011, Carrier contributed 28 of its company-owned locations in eight Northeast U.S. states, and we contributed 14 locations in the Northeast U.S. In July 2011, we purchased Carrier's distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We

have a 60% controlling interest in Carrier Enterprise II, and Carrier has a 40% noncontrolling interest. Neither we nor Carrier has any options to purchase additional ownership interests in Carrier Enterprise II.

In April 2012, we formed a third joint venture, which we refer to as Carrier Enterprise III, with UTC Canada Corporation, referred to as UTC Canada, an affiliate of Carrier. Carrier contributed 35 of its company-owned locations in Canada to Carrier Enterprise III. We have a 60% controlling interest in Carrier Enterprise III, and UTC Canada has a 40% noncontrolling interest. Neither we nor UTC Canada has any options to purchase additional ownership interests in Carrier Enterprise III.

### **Critical Accounting Policies**

Management's discussion and analysis of financial condition and results of operations is based upon the condensed consolidated unaudited financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the condensed consolidated unaudited financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. At least quarterly, management reevaluates its judgments and estimates, which are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances.

Our critical accounting policies are included in our 2012 Annual Report on Form 10-K as filed on February 28, 2013. We believe that there have been no significant changes during the quarter ended September 30, 2013 to the critical accounting policies disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.

### Recent Accounting Pronouncements

Refer to Note 1 to our condensed consolidated unaudited financial statements included in this Quarterly Report on Form 10-Q for a discussion of new accounting standards.

### Results of Operations

The following table summarizes information derived from the condensed consolidated unaudited statements of income expressed as a percentage of revenues for the quarters and nine months ended September 30, 2013 and 2012:

	Quarter Ended		Nine Months	
	September 30,		Ended September 30,	
	2013	2012	2013	2012
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of sales	76.1	76.2	76.0	76.3
Gross profit	23.9	23.8	24.0	23.7
Selling, general and administrative expenses	15.1	15.4	16.1	16.5
Operating income	8.8	8.4	7.9	7.2
Interest expense, net	0.2	0.1	0.1	0.1
Income before income taxes	8.6	8.3	7.8	7.1
Income taxes	2.5	2.5	2.3	2.1
Net income	6.1	5.8	5.5	5.0
Less: net income attributable to noncontrolling interest	1.9	1.8	1.7	1.7
Net income attributable to Watsco, Inc.	4.2%	4.0%	3.8%	3.3%

The following narratives include the results of operations for businesses acquired during 2012. The results of operations for these acquisitions have been included in our condensed consolidated unaudited statements of income beginning on the respective dates of acquisition. See Note 6 to our condensed consolidated unaudited financial statements included in this Quarterly Report on Form 10-Q for the pro forma financial information combining our results of operations with the operations of Carrier Enterprise III. The following narratives also reflect our acquisition of an additional 10% ownership interest in Carrier Enterprise I, which became effective on July 2, 2012. We did not acquire any businesses during the nine months ended September 30, 2013.

In the following narratives, computations and disclosure information referring to same-store basis exclude the effects of locations acquired or locations opened or closed during the immediately preceding 12 months unless they are within close geographical proximity to existing locations. At September 30, 2013 and 2012, 20 and 62 locations, respectively, were excluded from same-store basis information. The table below summarizes the changes in our locations for the 12 months ended September 30, 2013:

	<b>Number of Locations</b>
September 30, 2012	579
Closed	(6)
December 31, 2012	573
Opened	6
Closed	(8)
September 30, 2013	571

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## Third Quarter 2013 Compared to Third Quarter 2012

### *Revenues*

Revenues for the quarter ended September 30, 2013 increased \$61.0 million, or 6%, compared to the same period in 2012, including \$1.0 million from locations opened during the preceding 12 months, partially offset by \$3.2 million from closed locations. On a same-store basis, revenues increased \$63.2 million, or 6%, as compared to the same period in 2012, reflecting an 8% increase in sales of HVAC equipment (9% increase in residential HVAC equipment and a 3% increase in commercial HVAC equipment), a 3% increase in sales of other HVAC products and a 1% increase in sales of commercial refrigeration products. The increase in same-store revenues is primarily due to strong demand for residential HVAC equipment.

### *Gross Profit*

Gross profit for the quarter ended September 30, 2013 increased \$16.1 million, or 7%, compared to the same period in 2012, primarily as a result of increased revenues. Gross profit margin for the quarter ended September 30, 2013 improved 10 basis-points to 23.9% versus 23.8% for the same period in 2012, primarily due to higher realized gross margins for non-equipment products.

### *Selling, General and Administrative Expenses*

Selling, general and administrative expenses for the quarter ended September 30, 2013 increased \$6.3 million, or 4%, compared to the same period in 2012, primarily as a result of increased revenues. Selling, general and administrative expenses as a percent of revenues for the quarter ended September 30, 2013 decreased to 15.1% from 15.4% for the same period in 2012. The decrease in selling, general, and administrative expenses as a percentage of revenues was primarily due to leveraging of fixed operating costs as compared to 2012. For the quarter ended September 30, 2012, selling, general and administrative expenses included \$0.4 million of acquisition-related costs.

### *Interest Expense, Net*

Net interest expense for the quarter ended September 30, 2013 increased \$0.6 million, or 50%, compared to the same period in 2012, primarily as a result of an increase in average outstanding borrowings, partially offset by a lower effective interest rate in 2013 as compared to 2012.

### *Income Taxes*

Income taxes increased to \$27.6 million for the quarter ended September 30, 2013 as compared to \$25.0 million for the quarter ended September 30, 2012 and are a composite of the income taxes attributable to our wholly owned operations and investments, and income taxes attributable to the Carrier joint ventures, which are taxed as partnerships for income tax purposes. The effective income tax rate attributable to us was 37.0% for both the quarters ended September 30, 2013 and 2012.

### *Net Income Attributable to Watsco, Inc.*

Net income attributable to Watsco for the quarter ended September 30, 2013 increased \$4.7 million, or 11%, compared to the same period in 2012. The increase was primarily driven by higher revenues, expanded profit margins and reduced selling, general and administrative expenses as a percent of revenues, as discussed above.

## Nine Months Ended September 30, 2013 Compared to Nine Months Ended September 30, 2012

*Revenues*

Revenues for the nine months ended September 30, 2013 increased \$249.8 million, or 9%, compared to the same period in 2012, including \$87.4 million attributable to the 35 new Carrier Enterprise III locations acquired in 2012, and \$1.9 million from other locations opened during the preceding 12 months, partially offset by \$6.1 million from closed locations. On a same-store basis, revenues increased \$166.6 million, or 6%, as compared to the same period in 2012. Revenues reflect an 8% increase in sales of HVAC equipment (11% increase in residential HVAC equipment offset by a 2% decrease in commercial HVAC equipment), a 3% increase in sales of other HVAC products and a 4% increase in sales of commercial refrigeration products. The increase in same-store revenues is primarily due to strong demand for residential HVAC equipment.

*Gross Profit*

Gross profit for the nine months ended September 30, 2013 increased \$69.1 million, or 11%, compared to the same period in 2012, primarily as a result of increased revenues. Gross profit margin for the nine months ended September 30, 2013 improved 30 basis-points to 24.0% versus 23.7% for the same period in 2012, primarily due to higher realized gross margins for residential HVAC equipment and non-equipment products, and higher gross margins achieved by Carrier Enterprise III.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses for the nine months ended September 30, 2013 increased \$29.5 million, or 7%, compared to the same period in 2012, primarily as a result of increased revenues. Selling, general and administrative expenses as a percent of revenues for the nine months ended September 30, 2013 decreased to 16.1% from 16.5% for the same period in 2012. The decrease in

selling, general, and administrative expenses as a percentage of revenues was primarily due to leveraging of fixed operating costs as compared to 2012. For the nine months ended September 30, 2012, selling, general and administrative expenses included \$1.1 million of acquisition-related costs. On a same-store basis, selling, general, and administrative expenses increased 2% as compared to 2012.

#### *Interest Expense, Net*

Net interest expense for the nine months ended September 30, 2013 increased \$1.2 million, or 36%, compared to the same period in 2012, primarily as a result of an increase in average outstanding borrowings, partially offset by a lower effective interest rate in 2013 as compared to 2012.

#### *Income Taxes*

Income taxes increased to \$66.7 million for the nine months ended September 30, 2013 as compared to \$54.1 million for the nine months ended September 30, 2012 and are a composite of the income taxes attributable to our wholly owned operations and investments, and income taxes attributable to the Carrier joint ventures, which are taxed as partnerships for income tax purposes. The effective income tax rate attributable to us was 37.0% for both the nine months ended September 30, 2013 and 2012.

#### *Net Income Attributable to Watsco, Inc.*

Net income attributable to Watsco for the nine months ended September 30, 2013 increased \$21.8 million, or 25%, compared to the same period in 2012. The increase was primarily driven by higher revenues, expanded profit margins and reduced selling, general and administrative expenses as a percent of revenues as discussed above, and by a reduction in the net income attributable to the noncontrolling interest related to Carrier Enterprise I following our purchase of an additional 10% ownership interest in Carrier Enterprise I in July 2012.

### **Liquidity and Capital Resources**

We assess our liquidity in terms of our ability to generate cash to execute our business strategy and fund operating and investing activities, taking into consideration the seasonal demand of HVAC/R products, which peaks in the months of May through August. Significant factors that could affect our liquidity include the following:

cash necessary to fund our business (primarily working capital requirements);

the adequacy of our available bank line of credit;

the ability to attract long-term capital with satisfactory terms;

acquisitions;

dividend payments;

capital expenditures; and

the timing and extent of common stock repurchases.

#### Sources and Uses of Cash

We rely on cash flows from operations and borrowing capacity (subject to certain restrictions) under our revolving credit agreement to fund seasonal working capital needs and for other general corporate purposes, including anticipated dividend payments, capital expenditures, business acquisitions and development of our long-term operating strategies.

As of September 30, 2013, we had \$29.2 million of cash and cash equivalents, of which, \$19.1 million was held by foreign subsidiaries. We believe that our operating cash flows, cash on hand and funds available for borrowing under our line of credit will be sufficient to meet our liquidity needs in the foreseeable future. However, there can be no assurance that our current sources of available funds will be sufficient to meet our cash requirements.

Our access to funds under the line of credit is dependent on the ability of the syndicate banks to meet their respective funding commitments. Disruptions in the capital and credit markets could adversely affect our ability to draw on our line of credit and may also affect the determination of interest rates for borrowers, particularly rates based on LIBOR, which is one of the base rates under our line of credit. Any disruptions in these markets could result in increased borrowing costs and/or reduced borrowing capacity under our line of credit.

#### Working Capital

Working capital increased to \$850.0 million at September 30, 2013 from \$733.1 million at December 31, 2012, reflecting higher levels of accounts receivable and inventories, primarily due to the seasonality of our business.

Cash Flows

The following table summarizes our cash flow activity for the nine months ended September 30, 2013 and 2012:

	<b>2013</b>	<b>2012</b>	<b>Change</b>
Cash flows provided by operating activities	<b>\$ 51.2</b>	\$ 64.4	\$ (13.2)
Cash flows used in investing activities	<b>\$ (10.7)</b>	\$ (89.3)	\$ 78.6
Cash flows (used in) provided by financing activities	<b>\$ (84.7)</b>	\$ 54.8	\$ (139.5)

The individual items contributing to cash flow changes for the periods presented are detailed in the condensed consolidated unaudited statements of cash flows contained in this Quarterly Report on Form 10-Q.

Operating Activities

The decrease in net cash provided by operating activities was principally attributable to changes in operating assets and liabilities, which were primarily composed of lower levels of accounts payable and other liabilities due to approximately \$18.0 million in incremental vendor payments from a one-time change in payment terms related to Carrier Enterprise II and higher accounts receivable driven by increased sales volume in 2013.

Investing Activities

The decrease in net cash used in investing activities is due to the purchase of our 60% controlling interest in Carrier Enterprise III for cash consideration of \$80.5 million in 2012 partially offset by higher capital expenditures in 2013.

Financing Activities

The decrease in net cash provided by financing activities was primarily attributable to lower net borrowings under our revolving credit agreement and an increase in distributions to the noncontrolling interest in 2013, partially offset by the exercise of our option to acquire an additional 10% ownership interest in Carrier Enterprise I for \$51.9 million in 2012 and a decrease in dividends paid in 2013.

Revolving Credit Agreement

We maintain an unsecured, syndicated revolving credit agreement that provides for borrowings of up to \$500.0 million. Borrowings are used to fund seasonal working capital needs and for other general corporate purposes, including acquisitions, dividends, stock repurchases and issuances of letters of credit. At September 30, 2013 and December 31, 2012, \$284.8 million and \$316.2 million were outstanding under the revolving credit agreement, respectively. The revolving credit agreement contains customary affirmative and negative covenants, including financial covenants with respect to consolidated leverage and interest coverage ratios, and other customary restrictions. We believe we were in compliance with all covenants at September 30, 2013.

On July 1, 2013, we entered into an amendment to the revolving credit agreement, which extended the maturity date from April 27, 2017 to July 1, 2018, reduced pricing, improved covenant flexibility to reflect the seasonal nature of our working capital requirements and modified certain definitions. Borrowings under the amended credit facility bear interest at either LIBOR-based rates plus a spread, which ranges from 87.5 to 250 basis-points, depending upon our ratio of total debt to EBITDA, or on rates based on the higher of the Prime rate or the Federal Funds Rate, in each case plus a spread which ranges from 0 to 150 basis-points, depending upon our ratio of total debt to EBITDA. We pay a variable commitment fee on the unused portion of the commitment under the amended credit facility, ranging from 12.5 to 35 basis-points.

Acquisitions

We continually evaluate potential acquisitions and/or joint ventures and routinely hold discussions with a number of acquisition candidates. Should suitable acquisition opportunities arise that would require additional financing, we believe our financial position and earnings history provide a sufficient basis for us to either obtain additional debt financing at competitive rates and on reasonable terms or raise capital through the issuance of equity securities.

Common Stock Dividends

We paid cash dividends of \$0.75 per share and \$1.86 per share of Common stock and Class B common stock during the nine months ended September 30, 2013 and 2012, respectively. On October 2, 2013, our Board of Directors declared a regular quarterly cash dividend of \$0.40 per share of Common stock and Class B common stock that was paid on October 31, 2013 to shareholders of record as of October 15, 2013. Future dividends and/or dividend rate increases will be at the sole discretion of the Board of Directors and will depend upon such factors as cash flow generated by operations, profitability, financial condition, cash requirements, future prospects and other factors deemed relevant by our Board of Directors.

### **ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the normal course of business we are exposed to fluctuations in foreign currency exchange rates and interest rates. To manage certain of these exposures, we use derivative financial instruments, including forward contracts and swaps. We do not use derivative financial instruments for trading purposes.

Information with respect to this item may be found in Note 4 to our condensed consolidated unaudited financial statements contained in this Quarterly Report on Form 10-Q, which information is incorporated by reference in this Item 3 of Part I of this Quarterly Report on Form 10-Q. There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures about Market Risk, of the Annual Report on Form 10-K for the year ended December 31, 2012.

### **ITEM 4. CONTROLS AND PROCEDURES**

#### **Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended ( the Exchange Act )) that are, among other things, designed to ensure that information required to be disclosed by us under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer ( CEO ), Senior Vice President ( SVP ) and Chief Financial Officer ( CFO ), to allow for timely decisions regarding required disclosure and appropriate SEC filings.

Our management, with the participation of our CEO, SVP and CFO, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, and, based on that evaluation, our CEO, SVP and CFO concluded that our disclosure controls and procedures were effective, at a reasonable assurance level, at and as of such date.

#### **Changes in Internal Control over Financial Reporting**

We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout the Company. However, there have been no changes in internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2013, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In accordance with the rules and regulations of the SEC, we have not yet assessed the internal control over financial reporting of the 35 locations added by Carrier Enterprise III on April 27, 2012, which represents approximately 17% of our consolidated assets at September 30, 2013 and approximately 8% of our consolidated revenues for the nine months ended September 30, 2013. From the acquisition date to September 30, 2013, the processes and systems of Carrier Enterprise III did not impact the internal controls over financial reporting for our other consolidated subsidiaries.

## **PART II. OTHER INFORMATION**

### **ITEM 1. LEGAL PROCEEDINGS**

Information with respect to this item may be found in Note 9 to our condensed consolidated unaudited financial statements contained in this Quarterly Report on Form 10-Q under the caption Litigation, Claims and Assessments, which information is incorporated by reference in this Item 1 of Part II of this Quarterly Report on Form 10-Q.

**ITEM 1A. RISK FACTORS**

Information about risk factors for the quarter ended September 30, 2013 does not differ materially from that set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the year ended December 31, 2012.

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**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

The following table provides information with respect to purchases we made of our common stock during the quarter ended September 30, 2013:

Period		Issuer Purchases of Equity Securities			
		Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Program	Maximum Number of Shares that May Yet be Purchased under the Program
July 1	July 31				
August 1	August 31	5,448	\$ 89.96		
September 1	September 30				
Total		5,448	\$ 89.96		

- (1) Reflects shares of Class B common stock delivered as payment for the exercise price of options exercised and related tax withholdings associated with our 2001 Incentive Compensation Plan.

**ITEM 6. EXHIBITS**

- 10.1 Amendment No. 2, dated as of July 1, 2013, to Credit Agreement dated as of April 27, 2012, by and among Watsco, Inc., as Borrower, Watsco Canada, Inc., as Canadian Borrower, the Lenders From Time to Time Party Thereto, JPMorgan Chase Bank, N.A., as Administrative Agent and Collateral Agent, Bank of America, N.A. and Wells Fargo Bank, National Association as Co-Syndication Agents and U.S. Bank National Association as Documentation Agent, filed as Exhibit 10.1 to our Current Report on Form 8-K filed with the SEC on July 2, 2013 and incorporated by reference herein.
- 31.1 # Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 # Certification of Senior Vice President pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.3 # Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 + Certification of Chief Executive Officer, Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.

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101.INS # XBRL Instance Document.  
101.SCH # XBRL Taxonomy Extension Schema Document.  
101.CAL # XBRL Taxonomy Extension Calculation Linkbase Document.  
101.DEF # XBRL Taxonomy Extension Definition Linkbase Document.  
101.LAB # XBRL Taxonomy Extension Label Linkbase Document.  
101.PRE # XBRL Taxonomy Extension Presentation Linkbase Document.

# filed herewith.

+ furnished herewith.

**SIGNATURE**

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.

WATSCO, INC.  
(Registrant)

By: /s/ Ana M. Menendez  
Ana M. Menendez  
Chief Financial Officer  
(on behalf of the Registrant and as  
Principal Financial Officer)

November 1, 2013

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**INDEX TO EXHIBITS**

<b>Exhibit No.</b>	<b>Exhibit Description</b>
10.1	Amendment No. 2, dated as of July 1, 2013, to Credit Agreement dated as of April 27, 2012, by and among Watsco, Inc., as Borrower, Watsco Canada, Inc., as Canadian Borrower, the Lenders From Time to Time Party Thereto, JPMorgan Chase Bank, N.A., as Administrative Agent and Collateral Agent, Bank of America, N.A. and Wells Fargo Bank, National Association as Co-Syndication Agents and U.S. Bank National Association as Documentation Agent, filed as Exhibit 10.1 to our Current Report on Form 8-K filed with the SEC on July 2, 2013 and incorporated by reference herein.
31.1 #	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 #	Certification of Senior Vice President pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.3 #	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 +	Certification of Chief Executive Officer, Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002.
101.INS #	XBRL Instance Document.
101.SCH #	XBRL Taxonomy Extension Schema Document.
101.CAL #	XBRL Taxonomy Extension Calculation Linkbase Document.
101.DEF #	XBRL Taxonomy Extension Definition Linkbase Document.
101.LAB #	XBRL Taxonomy Extension Label Linkbase Document.
101.PRE #	XBRL Taxonomy Extension Presentation Linkbase Document.

# filed herewith.

+ furnished herewith.