

## Watsco Inc. (WSO)

**\$177.70** (As of 06/30/20)

Price Target (6-12 Months): **\$186.00**

Long Term: 6-12 Months

**Zacks Recommendation:**
**Neutral**

(Since: 04/29/19)

Prior Recommendation: Underperform

Short Term: 1-3 Months

**Zacks Rank:** (1-5)

**2-Buy**

Zacks Style Scores:

VGM:B

Value: C

Growth: B

Momentum: B

## Summary

Shares of Watsco have outperformed the industry so far this year. The company has been witnessing softness in a few international markets served. Digitization of business and incremental technology spending has been substantially increasing its expenses over the past few years. The recent economic slowdown led by shutdowns caused by the outbreak of coronavirus has been concerning the company. Although the e-commerce business is gaining traction in recent time owing to stay-at-home orders issued by the government, its April sales registered a decline. Nonetheless, estimates for 2020 earnings have moved north over the past seven days, reflecting analysts' optimism over Watsco's prospects.

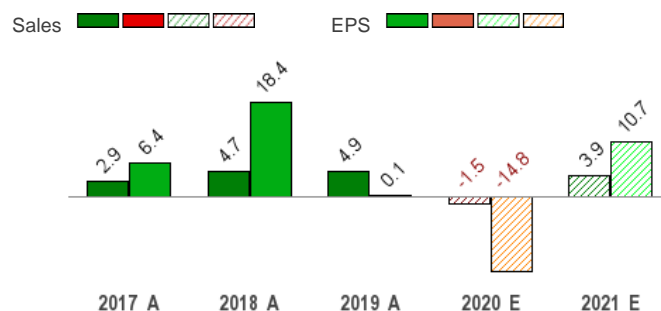
## Price, Consensus & Surprise



## Data Overview

52 Week High-Low	\$186.87 - \$132.97
20 Day Average Volume (sh)	246,857
Market Cap	\$6.8 B
YTD Price Change	-1.4%
Beta	0.68
Dividend / Div Yld	\$7.10 / 4.0%
Industry	<a href="#">Building Products - Air Conditioner and Heating</a>
Zacks Industry Rank	Bottom 4% (242 out of 253)

## Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-18.2%
Last Sales Surprise	-0.6%
EPS F1 Est- 4 week change	2.4%
Expected Report Date	07/16/2020
Earnings ESP	14.4%

P/E TTM	28.5
P/E F1	32.1
PEG F1	2.6
P/S TTM	1.4

## Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	1,028 E	1,315 E	1,414 E	1,086 E	4,882 E
2020	1,008 A	1,294 E	1,323 E	1,058 E	4,699 E
2019	931 A	1,372 A	1,395 A	1,072 A	4,770 A

## EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.78 E	\$2.03 E	\$2.17 E	\$0.92 E	\$6.13 E
2020	\$0.72 A	\$1.93 E	\$1.89 E	\$0.84 E	\$5.54 E
2019	\$0.88 A	\$2.40 A	\$2.20 A	\$0.92 A	\$6.50 A

\*Quarterly figures may not add up to annual.

The data in the charts and tables, including the Zacks Consensus EPS and Sales estimates, is as of 06/30/2020. The reports text is as of 07/01/2020.

## Overview

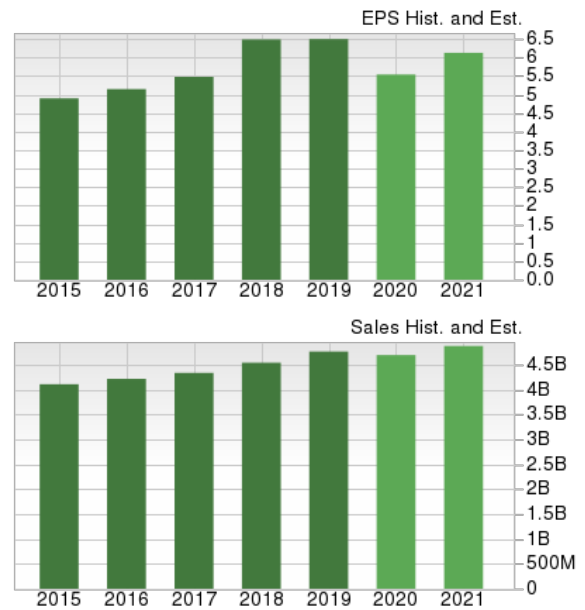
Watsco, is the largest distributor of Heating, ventilation and air conditioning equipment as well as related parts and supplies (HVAC/R) in the United States. It distributes residential and commercial air conditioners; parts such as replacement compressors, evaporator coils and motors; as well as supplies such as thermostats, insulation materials, refrigerants, grills, registers, sheet metal, tools, concrete pads, tape, and adhesives. Its air conditioning and heating equipment is sold to the residential replacement market, the commercial market and residential new construction market.

Watsco distributes products in 603 locations (as of Mar 31, 2020) in the United States, Canada, Mexico and Puerto Rico, and on an export basis to Latin America and the Caribbean. Of these, no single location accounts for more than 3% of total revenues. The company sources supply from main industry players including Rheem, Carrier, Nordyne, Goodman, Trane, and Lennox.

Revenues as disaggregated by the company per major product lines within single reporting segment are as follows:

HVAC equipment contributed 68% to 2019 revenues, Other HVAC products accounted for 28% and Commercial refrigeration products constituted 4%.

As of Mar 31, 2020, cash and cash equivalents were \$51.2 million compared with \$74.5 million at 2018-end. Cash from operations came in at \$41.9 million in the first three months of 2020 compared with \$52.9 million in the comparable year-ago period.



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## Reasons To Buy:

▲ **Technology Enhancement:** As the digital era progresses, speed, productivity and efficiency will be more critical. Consequently, the company is investing to improve customer experience through e-commerce. Watsco is deploying technology that improves order fill rates with speed and accuracy. It has the industry's largest database of digitized product information, with more than 728,000 SKUs. Driven by various technology platforms, the company's e-commerce platform sold more than \$1.4 billion products in the past 12 months. On-line sales in first-quarter 2020 grew 12% year over year. Current run-rate for e-commerce sales expanded to 36% from 29% at 2019-end. Transactions increased 13% from a year ago.

Continued investment in the technologies, acquisitions along with strong unit demand, higher pricing and sales mix are growth drivers

During the lockdown/shutdowns caused by the coronavirus outbreak, Watsco is aggressively leveraging technology platforms to better serve, and protect customers and employees. The company launched "contactless" sales and servicing capabilities amid the current environment. Notably, average-weekly users of its mobile apps surged 94% from a year ago to more than 25,000. On a further encouraging note, it filled 33% more orders using the digitized fulfillment software in its locations during the quarter.

Business intelligence and data analytics expertise will aid insightful assistance and decision-making by managers. During the first quarter, investment in technology increased \$1.1 million. The company remains optimistic about its innovative technology and expects to survive in this unprecedented period.

▲ **Strategic Acquisitions:** Acquisitions have been Watsco's preferred mode of solidifying its product portfolio and leveraging new business opportunities in a bid to increase the customer base and profitability. Watsco invested \$148 million of capital in 2019 through a combination of cash and shares in market-leading businesses. On Dec 3, 2019, Watsco acquired Fishkill, NY-based N&S Supply — a distributor of air conditioning, heating and plumbing products. N&S Supply serves more than 10,000 customers and offers approximately 40,000 stock keeping units or SKUs that include air conditioning and heating equipment, hydronic heating equipment, complimentary parts and supplies, along with a variety of plumbing products. The buyout expanded Watsco's sales presence in the Northeast United States.

On Aug 1, 2019, it acquired Peirce-Phelps, Inc., which is one of the largest HVAC distributors in North America and serves more than 9,000 contractor-customers.

In 2019, the company also acquired DASCO Supply, a seller of HVAC products. DASCO operates in seven locations, and serves more than 2,500 customers in New Jersey, New York and Connecticut. The company also purchased an additional 1.8% ownership interest in Russell Sigler, Inc. (RSI), which sells HVAC products from 30 locations throughout the Western U.S. Again, the buyout of 20% of Homans Associates from Carrier Corporation raised Watsco's ownership from 80% to 100%. These buyouts are boosting Watsco's customer base and profitability. Also, the acquisitions will help the company in leveraging technology investment, enhancing productivity and reducing costs.

▲ **Driving Shareholder Value:** On Apr 1, Watsco raised annual dividend by 11% to \$7.10 per share. Notably, 2020 marks the 46th consecutive year of dividend payment. Notably, in 2019, the company paid dividends of \$241 million, up 15% year over year. Since 2000, the company's cash flow came in at approximately \$2.7 billion, more than net income of roughly \$2.6 billion, meeting its stated goal of generating cash flow in excess of net income. Consequently, the company continues to look for investments to grow network, as well as invest in acquisitions or mergers.

▲ **Enough Liquidity to Meet the Crisis:** Watsco has a strong balance sheet position and enough liquidity to manage the ongoing crisis. The company's long-term debt (which includes borrowings under the revolving credit agreement and operating lease liabilities) in first-quarter 2020 decreased to \$308 million from \$312 million in the prior quarter. The company ended the quarter with cash and cash equivalents of \$51.2 million, lower than \$74.5 million at 2019-end. Although its current cash level is lower sequentially, its \$156 million of borrowings under the \$560-million credit facility is sufficient to meet the short-term obligation of \$69 million.

Its debt to capital at March-end was 18.3% (in line on a sequential basis), comparing favorably with 40.7% for the industry. Moreover, the company's times interest earned ratio stands at 88.2, better than the industry's 22.8. The times-interest-earned ratio is very important for some companies, as it measures a company's ability to meet debt obligations based on current income.

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## Reasons To Sell:

▼ **Lackluster Performance:** Watsco delivered a negative earnings surprise in first-quarter 2020. On a further discouraging note, its earnings declined 18.2% year over year in the first quarter. Lower margins due to higher costs and expenses affected the results. Notably, the company has dismal earnings and revenues surprise history. It missed the consensus mark for earnings in 16 of the last 19 quarters, owing to extreme weather conditions, certain incremental costs and weakness in international markets served. The company's top line also missed the consensus mark in 20 of the trailing 24 quarters.

Moreover, the recent economic slowdown caused by coronavirus-induced lockdown/shutdowns is putting pressure on many industries. Although the e-commerce business is gaining traction in recent times owing to stay-at-home orders led by the government, its April sales registered a decline. Although it has been adjusting business per the needs of customers, reducing costs in affected markets and improving efficiency, we wait for better visibility.

▼ **Higher Tariff is a Pressing Concern:** Any upward price pressure on raw materials may pressurize the company's margins. Notably, HVAC equipment and component manufacturers, including Carrier and Rheem, source component parts from China or assemble a significant number of products for residential and light-commercial applications from Mexico. Now that trade tensions have crept up, any restrictions or significant increases in tariffs related to such products sourced or assembled from Mexico and China would compel the company to raise prices. This may result in cost inflation and loss of customers, and harm business.

▼ **Seasonal Sales:** Sales of residential central air conditioners, heating equipment, and parts and supplies have historically been seasonal. Watsco's profitability will be impacted favorably or unfavorably, based on the severity or mildness of weather patterns during the summer or winter selling seasons. Notably, in June 2019, the company witnessed extreme weather conditions in certain markets served, somewhat offsetting the positives generated from technology enhancement and acquisitions.

▼ **Cutthroat Competition:** The HVAC/R distribution industry is highly competitive. Watsco competes with other distributors, and several air conditioning and heating equipment manufacturers that distribute a major portion of their products through their own distribution organizations in certain markets. Competitive pressures could result in price erosion or reduction in market acceptance, all of which would have an adverse impact on its operations, cash flows, and liquidity.

Watsco's top ten suppliers accounted for 83% of its purchases during 2019, including 62% from Carrier and 9% from Rheem. Given the significant concentration of its supply chain, particularly with Carrier and Rheem, any significant interruption by any of the key manufacturers or a termination of a relationship could temporarily disrupt the operations of certain of our subsidiaries.

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Coronavirus fears, higher tariffs and intense competition mar the company's prospects.

## Last Earnings Report

### Watsco Q1 Earnings Lag Estimates, On-Line Sales Up Y/Y

Watsco, Inc. reported disappointing results in first-quarter 2020. Earnings and revenues missed the respective Zacks Consensus Estimate. Also, its bottom line declined on a year-over-year basis due to softness in international markets.

Given the current market conditions, the company noted that sales trends have decelerated in April and will vary according to geography in the summer selling season. It has been adjusting business per the needs of customers, reducing costs in affected markets and improving efficiency.

The company believes that financial strength, backed by its highly-conservative leverage ratios, access to low-cost capital and ability to generate cash flow, allows it to take advantage of almost any size investment opportunity.

#### Inside the Numbers

Watsco's quarterly earnings of 72 cents per share missed the consensus estimate of 88 cents. The reported earnings also declined 18.2% year over year. Lower margins due to higher costs and expenses affected the results.

Total revenues of \$1.01 billion lagged the consensus mark of \$1.02 billion by 0.6% but increased 8.3% from the year-ago period. Sales grew 2% on a same-store basis. The upside stemmed from strong HVAC equipment business, partially offset by soft demand in a few international markets served. Continued investment in technologies designed to revolutionize customer experience added to the positives. Notably, on-line sales in quarter grew 12% year over year on 13% increased e-commerce transactions.

Sales of HVAC equipment (heating, ventilating and air conditioning; comprising 67% of sales) were up 2% year over year, including 5% growth in U.S. residential markets. Sales of other HVAC products (29% of sales) increased 2% from the prior-year quarter. Sales from commercial refrigeration products (4% of sales) were flat year over year.

#### Operating Highlights

Gross margin contracted 50 basis points (bps) to 24.6%. SG&A expenses increased 13% year over year due to the addition of 35 new or acquired locations. In fact, SG&A expenses — as a percentage of sales — surged 90 bps year over year. Operating margin contracted 140 bps year over year to 4.5%.

#### Financial Operations

As of Mar 31, 2020, cash and cash equivalents were \$51.2 million compared with \$74.5 million at 2018-end. Cash from operations came in at \$41.9 million in the first three months of 2020 compared with \$52.9 million in the comparable year-ago period.

Quarter Ending **03/2020**

Report Date	<b>Apr 23, 2020</b>
Sales Surprise	<b>-0.64%</b>
EPS Surprise	<b>-18.18%</b>
Quarterly EPS	<b>0.72</b>
Annual EPS (TTM)	<b>6.24</b>

## Valuation

Watsco's shares are down 1.3% in the year-to-date period but up 8.4% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Construction sector are down 2.5% and 8.3% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector are up 8.4% and 3.7%, respectively.

The S&P 500 index is down 3.7% in the year-to-date period but up 4.9% in the past year.

The stock is currently trading at 30.53X forward 12-month earnings, which compares to 30.98X for the Zacks sub-industry, 18.86X for the Zacks sector and 21.87X for the S&P 500 index.

Over the past five years, the stock has traded as high as 31.9X and as low as 18.86X, with a 5-year median of 24.29X. Our Neutral recommendation indicates that the stock will perform in-line with the market. Our \$186 price target reflects 32.07X forward 12-month earnings.

The table below shows summary valuation data for WSO.

Valuation Multiples - WSO					
		Stock	Sub-Industry	Sector	S&P 500
P/E F12M	Current	30.53	30.98	19.02	21.87
	5-Year High	31.9	30.98	19.02	22.14
	5-Year Low	18.86	19.42	10.74	15.25
	5-Year Median	24.29	24.05	15.86	17.52
P/S F12M	Current	1.42	1.26	1.94	3.42
	5-Year High	1.54	2.01	2.12	3.44
	5-Year Low	0.88	1.17	1.17	2.5
	5-Year Median	1.2	1.71	1.62	3.02
EV/EBITDA TTM	Current	21.25	18.22	17.37	11.31
	5-Year High	22.3	19.98	21.24	12.86
	5-Year Low	13.62	13.87	12.43	8.25
	5-Year Median	18.31	17.56	17.89	10.85

As of 06/30/2020

## Industry Analysis Zacks Industry Rank: Bottom 4% (242 out of 253)



## Top Peers

Company (Ticker)	Rec	Rank
Colfax Corporation (CFX)	Neutral	3
Chart Industries, Inc. (GTLS)	Neutral	2
HD Supply Holdings, Inc. (HDS)	Neutral	3
Hudson Technologies, Inc. (HDSN)	Neutral	3
AAON, Inc. (AAON)	Underperform	5
Comfort Systems USA, Inc. (FIX)	Underperform	3
Lennox International, Inc. (LII)	Underperform	5
Tecogen Inc. (TGEN)	Underperform	5

Industry Comparison Industry: Building Products - Air Conditioner And Heating				Industry Peers		
	WSO	X Industry	S&P 500	AAON	FIX	LII
Zacks Recommendation (Long Term)	Neutral	-	-	Underperform	Underperform	Underperform
Zacks Rank (Short Term)	2	-	-	5	3	5
VGM Score	B	-	-	B	A	F
Market Cap	6.82 B	2.16 B	21.75 B	2.82 B	1.49 B	8.91 B
# of Analysts	8	2	14	1	2	15
Dividend Yield	4.00%	0.87%	1.93%	0.70%	1.03%	1.32%
Value Score	C	-	-	F	A	F
Cash/Price	0.01	0.02	0.07	0.02	0.10	0.00
EV/EBITDA	18.07	17.17	12.71	30.87	8.25	16.27
PEG Ratio	2.55	NA	2.86	NA	NA	NA
Price/Book (P/B)	4.04	3.28	2.97	9.23	2.51	NA
Price/Cash Flow (P/CF)	25.03	17.57	11.71	36.98	9.15	17.57
P/E (F1)	31.94	30.91	21.23	41.44	17.27	29.77
Price/Sales (P/S)	1.41	1.41	2.30	5.73	0.54	2.38
Earnings Yield	3.12%	3.12%	4.48%	2.41%	5.79%	3.36%
Debt/Equity	0.18	0.13	0.76	0.00	0.68	-4.16
Cash Flow (\$/share)	7.10	4.45	7.01	1.47	4.45	13.26
Growth Score	B	-	-	A	A	D
Hist. EPS Growth (3-5 yrs)	7.86%	13.71%	10.93%	3.86%	26.39%	19.57%
Proj. EPS Growth (F1/F0)	-14.71%	-18.20%	-9.77%	28.43%	-21.33%	-30.06%
Curr. Cash Flow Growth	2.05%	4.71%	5.51%	26.97%	4.71%	13.08%
Hist. Cash Flow Growth (3-5 yrs)	11.37%	12.33%	8.62%	5.45%	31.42%	13.28%
Current Ratio	3.06	2.61	1.30	3.07	1.47	1.37
Debt/Capital	15.48%	15.48%	44.41%	0.00%	40.49%	NA
Net Margin	4.98%	4.98%	10.62%	13.37%	4.04%	9.42%
Return on Equity	14.23%	14.23%	15.75%	23.12%	19.26%	-160.44%
Sales/Assets	1.85	1.84	0.55	1.35	1.84	1.72
Proj. Sales Growth (F1/F0)	-1.49%	0.00%	-2.43%	0.00%	12.08%	-12.79%
Momentum Score	B	-	-	A	D	B
Daily Price Chg	1.97%	0.58%	1.41%	1.16%	1.82%	1.38%
1 Week Price Chg	-2.87%	-0.12%	-3.90%	-4.96%	-0.24%	1.60%
4 Week Price Chg	0.01%	2.69%	-1.62%	0.06%	4.70%	7.54%
12 Week Price Chg	17.41%	16.52%	15.67%	15.63%	22.23%	23.81%
52 Week Price Chg	8.45%	-9.51%	-8.07%	8.32%	-20.24%	-18.13%
20 Day Average Volume	246,857	175,225	2,699,706	217,622	248,377	323,340
(F1) EPS Est 1 week change	0.57%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	2.45%	0.00%	0.00%	0.00%	0.00%	0.05%
(F1) EPS Est 12 week change	-12.95%	-28.24%	-10.28%	-10.27%	-28.81%	-28.24%
(Q1) EPS Est Mthly Chg	3.77%	0.00%	0.00%	0.00%	0.00%	-3.18%

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## Zacks Stock Rating System

We offer two rating systems that take into account investors' holding horizons: Zacks Rank and Zacks Recommendation. Each provides valuable insights into the future profitability of the stock and can be used separately or in combination with each other depending on your investment style.

### Zacks Recommendation

The Zacks Recommendation aims to predict performance over the next 6 to 12 months. The foundation for the quantitatively determined Zacks Recommendation is trends in the company's estimate revisions and earnings outlook. The Zacks Recommendation is broken down into 3 Levels; Outperform, Neutral and Underperform. Unlike many Wall Street firms, we have an excellent balance between the number of Outperform and Neutral recommendations. Our team of 70 analysts are fully versed in the benefits of earnings estimate revisions and how that is harnessed through the Zacks quantitative rating system. But we have given our analysts the ability to override the Zacks Recommendation for the 1200 stocks that they follow. The reason for the analyst over-rides is that there are often factors such as valuation, industry conditions and management effectiveness that a trained investment professional can spot better than a quantitative model.

### Zacks Rank

The Zacks Rank is our short-term rating system that is most effective over the one- to three-month holding horizon. The underlying driver for the quantitatively-determined Zacks Rank is the same as the Zacks Recommendation, and reflects trends in earnings estimate revisions.

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### Zacks Style Scores

The Zacks Style Score is as a complementary indicator to the Zacks rating system, giving investors a way to focus on the highest rated stocks that best fit their own stock picking preferences.

Academic research has proven that stocks with the best Value, Growth and Momentum characteristics outperform the market. The Zacks Style Scores rate stocks on each of these individual styles and assigns a rating of A, B, C, D and F. We also produce the VGM Score (V for Value, G for Growth and M for Momentum), which combines the weighted average of the individual Style Scores into one score. This is perfectly suited for those who want their stocks to have the best scores across the board.

Value Score	C
Growth Score	B
Momentum Score	B
VGM Score	B

As an investor, you want to buy stocks with the highest probability of success. That means buying stocks with a Zacks Recommendation of Outperform, which also has a Style Score of an A or a B.

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