

## Watsco Inc. (WSO)

**\$176.70** (As of 01/21/20)

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: A

### Summary

Shares of Watsco has outperformed its industry in the past year. Earnings estimates for 2020 have remained stable over the past 60 days, reflecting optimism over the stock's growth prospects. Watsco is poised to benefit from strong industry fundamentals, including healthy replacement demand, confident consumers and rising price/mix. Watsco's investments in technology will likely translate into better cash flow and returns. Its focus on improving customer experience through e-commerce is encouraging. However, Digitization of business and incremental technology spending substantially increased its expenses over the past few years. Fluctuations in sales due to seasonal demand of residential air conditioners and heating equipment significantly hurt the company's profitability.

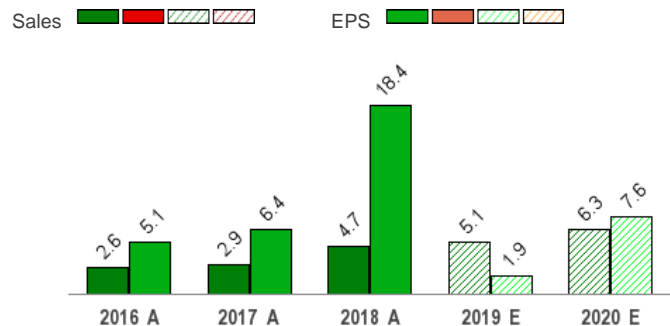
### Price, Consensus & Surprise



### Data Overview

52 Week High-Low	\$183.00 - \$136.45
20 Day Average Volume (sh)	141,648
Market Cap	\$6.7 B
YTD Price Change	-1.9%
Beta	0.82
Dividend / Div Yld	\$6.40 / 3.6%
Industry	<a href="#">Building Products - Air Conditioner and Heating</a>
Zacks Industry Rank	Top 27% (68 out of 255)

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



Last EPS Surprise	-2.2%
Last Sales Surprise	1.2%
EPS F1 Est- 4 week change	0.1%
Expected Report Date	02/13/2020
Earnings ESP	-5.6%
P/E TTM	27.2
P/E F1	24.9
PEG F1	2.0
P/S TTM	1.4

### Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2020	1,025 E	1,481 E	1,456 E	1,113 E	5,077 E
2019	931 A	1,372 A	1,395 A	1,081 E	4,777 E
2018	927 A	1,333 A	1,296 A	991 A	4,547 A

### EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2020	\$0.97 E	\$2.58 E	\$2.34 E	\$1.08 E	\$7.11 E
2019	\$0.88 A	\$2.40 A	\$2.20 A	\$1.01 E	\$6.61 E
2018	\$0.89 A	\$2.40 A	\$2.11 A	\$1.02 A	\$6.49 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 01/21/2020. The reports text is as of 01/22/2020.

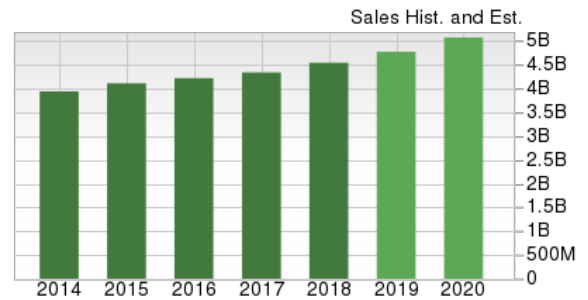
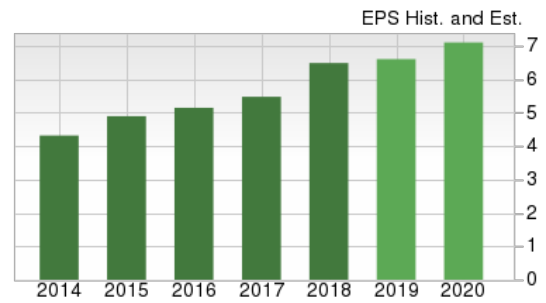
## Overview

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 Sep 30, 2019) in the United States, Canada, Mexico and Puerto Rico, and on an export basis to Latin America and the Caribbean. 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 69% to third-quarter revenues, Other HVAC products accounted for 27% and Commercial refrigeration products constituted 4%.



---

## 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 800,000 SKUs. Driven by various technology platforms, the company's e-commerce sales are expected to touch \$1.5 billion in 2019 (indicating a 25% increase from 2018). The number of unique users for mobile apps increased 15% to more than 88,000 so far this year.

Continued investment in the technologies designed to revolutionize Watsco's customer experience along with strong unit demand, higher pricing and sales mix are

Business intelligence and data analytics expertise will aid insightful assistance and decision-making by managers. During the first nine months of 2019, investment in technology increased \$4.3 million. The increase was driven by Watsco's acquisition of Alert Labs in August 2018.

Moreover, with the help of its data analytics platform, the company has launched a productivity initiative in order to identify cost-saving opportunities and enhance long-term profitability. The company is optimistic about this initiative and expects more advancement over the next few months.

Shares of Watsco has outperformed its industry in the past year. Earnings estimates for 2020 have remained stable over the past 60 days, reflecting optimism over the stock's growth prospects.

▲ **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 \$133 million of capital in the first nine months of 2019 through a combination of cash and shares in market-leading businesses. On Aug 1, 2019, Watsco acquired Peirce-Phelps, Inc., which is one of the largest HVAC distributors in North America. Operating in 19 locations in Pennsylvania, New Jersey and Delaware, Peirce-Phelps serves more than 9,000 contractor-customers.

This year, 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:** In January, Watsco raised its annual dividend by 10% to \$6.40 per share. Notably, 2019 marks the 45th consecutive year of dividend payment. Notably, in the first nine months of 2019, the company paid dividends of \$180 million, up 16% year over year. Since 2000, the company's cash flow came in at approximately \$2.4 billion compared with net income of roughly \$2.3 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.

▲ **Sunbelt Markets, a Major Growth Driver:** Watsco generates more than 70% of sales from Sunbelt markets, which consists of the southern tier of the United States, including the states of Alabama, Arizona, Florida, Georgia, Louisiana, Mississippi, New Mexico, South Carolina, Texas, roughly two-thirds of California, as well as parts of Arkansas, Colorado, Kansas, North Carolina, Oklahoma, Nevada, and Utah. The said market is not weather sensitive, hence concentration in the Sunbelt has been a fundamental component of Watsco's strategy over the past 30 years. Sunbelt has been a catalyst for growth in the installed base of HVAC systems. Warm weather patterns in the Sunbelt have consistently produced more dependable market conditions.

---

## Reasons To Sell:

▼ **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.

Seasonal factor, higher tariff and intense competition mar the prospects of the company

▼ **Higher Tariff is a Pressing Concern:** Any upward price pressure on raw materials in 2019 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.

▼ **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.

Again, Watsco's top ten suppliers accounted for 84% of its purchases during 2018, 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.

---

---

## Last Earnings Report

### Watsco's Q3 Earnings Miss, Revenues Beat Estimates

Watsco, reported mixed results in third-quarter 2019, wherein earnings missed the Zacks Consensus Estimate but sales beat the same. Notably, the company's shares jumped 5.6% on Oct 18, following the earnings release.

Quarterly earnings of \$2.20 per share lagged the consensus estimate of \$2.25 by 2.2%. Total sales of \$1,395 million surpassed the consensus mark of \$1,379 million by 1.2%.

On a year-over-year basis, the top and bottom lines grew 7.6% and 4.3%, respectively, given solid revenue contributions, benefits from the recent acquisitions, along with improved operating efficiencies.

On a same-store basis, sales increased 3% from the prior year.

Watsco is optimistic to post record revenues and earnings in 2019, courtesy of solid acquisition strategy and technology enhancement.

### Product Line Sales Discussion

Sales of HVAC (heating, ventilating and air conditioning) equipment — which accounted for 69% of sales — grew 4% from a year ago, owing to 6% growth in residential products. Also, sales of other HVAC products (27% of sales) and commercial refrigeration products (4%) increased 2% and 1%, respectively, from the prior-year quarter.

### Operating Highlights

Cost of sales grew 8.5% from the prior-year quarter to \$1.06 billion. Gross margin declined 60 basis points (bps) to 24%.

Selling, general & administrative (SG&A) expenses increased 6.2% from the year-ago quarter to \$212.5 million.

Operating income increased 2.5% from the prior-year period to \$125.3 million. However, operating margin fell 40 bps year over year to 9%.

### Financial Operations

As of Sep 30, 2019, the company had cash and cash equivalents of \$60.2 million compared with \$82.9 million at 2018-end. Cash provided by operations was \$197.5 million in the first nine months of 2019 compared with \$70 million net cash used for operations in the comparable year-ago period.

### Acquisitions

On Aug 1, 2019, Watsco acquired Peirce-Phelps, Inc. — one of the largest HVAC distributors in North America. With operations in 19 locations in Pennsylvania, New Jersey and Delaware, the company serves more than 9,000 contractor-customers.

---

Quarter Ending **09/2019**

Report Date	Oct 17, 2019
Sales Surprise	1.19%
EPS Surprise	-2.22%
Quarterly EPS	2.20
Annual EPS (TTM)	6.50

---

## Valuation

Watsco's shares are up 22.3% in the trailing 12-month period. Over the past year, the Zacks sub-industry and sector was up by 18.1% and 36.2%, respectively.

The S&P 500 index is up 25.4% in the past year.

The stock is currently trading at 24.87X forward 12-month price to earnings, which compares to 24.4X for the Zacks sub-industry, 16.11X for the Zacks sector and 19.18X for the S&P 500 index.

Over the past five years, the stock has traded as high as 30.45X and as low as 18.86X, with a 5-year median of 23.95X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$186 price target reflects 26.19X 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 F 12M	Current	24.87	24.4	16.11	19.18
	5-Year High	30.45	27.61	18.83	19.34
	5-Year Low	18.86	16.23	10.63	15.17
	5-Year Median	23.95	23.75	16.11	17.44
P/S F 12M	Current	1.33	1.48	1.94	3.57
	5-Year High	1.54	1.97	2.23	3.57
	5-Year Low	0.88	0.84	1.25	2.54
	5-Year Median	1.17	1.66	1.63	3
EV/EBITDA TTM	Current	20.33	18.12	19.57	12.38
	5-Year High	21.99	19.1	22.86	12.86
	5-Year Low	13.83	13.68	14.6	8.48
	5-Year Median	17.95	16.61	19.38	10.67

As of 01/21/2020

---

## Industry Analysis Zacks Industry Rank: Top 27% (68 out of 255)



## Top Peers

AAON, Inc. (AAON)	Neutral
Colfax Corporation (CFX)	Neutral
Comfort Systems USA, Inc. (FIX)	Neutral
Chart Industries, Inc. (GTLS)	Neutral
HD Supply Holdings, Inc. (HDS)	Neutral
Hudson Technologies, Inc. (HDSN)	Neutral
Lennox International, Inc. (LII)	Neutral
Tecogen Inc. (TGEN)	Neutral

Industry Comparison Industry: Building Products - Air Conditioner And Heating				Industry Peers		
	WSO Neutral	X Industry	S&P 500	AAON Neutral	FIX Neutral	LII Neutral
<b>VGM Score</b>	<b>B</b>	-	-	<b>C</b>	<b>A</b>	<b>A</b>
Market Cap	6.73 B	1.82 B	24.43 B	2.75 B	1.82 B	9.44 B
# of Analysts	8	2	13	1	2	19
Dividend Yield	3.62%	0.30%	1.75%	0.61%	0.81%	1.26%
<b>Value Score</b>	<b>C</b>	-	-	<b>F</b>	<b>A</b>	<b>C</b>
Cash/Price	0.01	0.01	0.04	0.01	0.02	0.01
EV/EBITDA	17.76	14.20	14.00	37.02	10.65	18.47
PEG Ratio	1.99	1.06	2.06	NA	NA	1.06
Price/Book (P/B)	3.84	3.26	3.39	9.85	3.26	NA
Price/Cash Flow (P/CF)	24.95	17.00	13.69	45.70	11.82	21.83
P/E (F1)	24.85	21.11	19.00	40.97	14.92	21.11
Price/Sales (P/S)	1.44	1.49	2.68	6.00	0.73	2.51
Earnings Yield	4.02%	4.74%	5.26%	2.44%	6.71%	4.74%
Debt/Equity	0.19	0.07	0.72	0.00	0.54	-4.25
Cash Flow (\$/share)	7.08	4.20	6.94	1.16	4.20	11.22
<b>Growth Score</b>	<b>B</b>	-	-	<b>A</b>	<b>A</b>	<b>A</b>
Hist. EPS Growth (3-5 yrs)	8.80%	15.24%	10.60%	2.62%	35.57%	21.68%
Proj. EPS Growth (F1/F0)	7.57%	15.25%	7.57%	30.30%	15.25%	3.51%
Curr. Cash Flow Growth	21.04%	21.04%	14.00%	-7.54%	49.41%	12.27%
Hist. Cash Flow Growth (3-5 yrs)	14.21%	13.56%	9.00%	4.20%	28.42%	12.91%
Current Ratio	3.12	2.30	1.23	3.16	1.30	1.19
Debt/Capital	15.79%	11.34%	42.99%	0.00%	35.08%	NA
Net Margin	5.29%	5.29%	11.15%	10.94%	4.24%	9.83%
Return on Equity	15.07%	15.07%	17.16%	19.11%	20.05%	-199.11%
Sales/Assets	1.90	1.90	0.55	1.39	1.97	1.78
Proj. Sales Growth (F1/F0)	6.26%	6.07%	4.05%	NA	5.87%	5.56%
<b>Momentum Score</b>	<b>A</b>	-	-	<b>D</b>	<b>B</b>	<b>A</b>
Daily Price Chg	0.90%	0.16%	-0.27%	-0.06%	0.32%	0.54%
1 Week Price Chg	0.01%	0.00%	2.29%	4.07%	2.59%	-1.57%
4 Week Price Chg	-2.83%	-2.61%	2.13%	6.12%	-2.61%	0.41%
12 Week Price Chg	0.16%	-1.33%	6.99%	6.36%	-3.69%	-1.33%
52 Week Price Chg	22.39%	9.36%	21.25%	40.26%	3.27%	9.36%
20 Day Average Volume	141,648	58,997	1,415,064	99,437	161,428	203,434
(F1) EPS Est 1 week change	0.09%	0.00%	0.00%	0.00%	0.00%	0.00%
(F1) EPS Est 4 week change	0.09%	0.00%	0.00%	0.00%	0.00%	0.60%
(F1) EPS Est 12 week change	1.45%	-1.55%	-0.34%	-14.00%	6.06%	-1.55%
(Q1) EPS Est Mthly Chg	0.21%	0.00%	0.00%	NA	NA	-0.63%

---

## 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.

---

### 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	A
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.

---

### Disclosures

**This report contains independent commentary to be used for informational purposes only. The analysts contributing to this report do not hold any shares of this stock. The analysts contributing to this report do not serve on the board of the company that issued this stock. The EPS and revenue forecasts are the Zacks Consensus estimates, unless indicated otherwise on the reports first page.** Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts personal views as to the subject securities and issuers. ZIR certifies that no part of the analysts compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report.

Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Any opinions expressed herein are subject to change.

ZIR is not an investment advisor and the report should not be construed as advice designed to meet the particular investment needs of any investor. Prior to making any investment decision, you are advised to consult with your broker, investment advisor, or other appropriate tax or financial professional to determine the suitability of any investment. This report and others like it are published regularly and not in response to episodic market activity or events affecting the securities industry.

This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. ZIR or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. ZIR is not a broker-dealer. ZIR may enter into arms-length agreements with broker-dealers to provide this research to their clients. Zacks and its staff are not involved in investment banking activities for the stock issuer covered in this report.

ZIR uses the following rating system for the securities it covers. **Outperform-** ZIR expects that the subject company will outperform the broader U.S. equities markets over the next six to twelve months. **Neutral-** ZIR expects that the company will perform in line with the broader U.S. equities markets over the next six to twelve months. **Underperform-** ZIR expects the company will underperform the broader U.S. equities markets over the next six to twelve months.

No part of this report can be reprinted, republished or transmitted electronically without the prior written authorization of ZIR.