

Watsco Inc. (WSO)

\$165.62 (As of 02/24/20)

Price Target (6-12 Months): **\$174.00**

Long Term: 6-12 Months

Zacks Recommendation:

Neutral

(Since: 04/29/19)

Prior Recommendation: Underperform

Short Term: 1-3 Months

Zacks Rank: (1-5)

4-Sell

Zacks Style Scores:

VGM:C

Value: D

Growth: A

Momentum: F

Summary

Shares of Watsco declined significantly post lackluster fourth-quarter 2019 results. Earnings and revenues missed the Zacks Consensus Estimate by 8.9% and 0.9%, respectively. Also, bottom line declined 9.8% on a year-over-year basis due to higher SG&A expenses. Digitization of business and incremental technology spending has been substantially increasing its expenses over the past few years. Fluctuations in sales due to seasonal demand of residential air conditioners and heating equipment are significantly hurting the company's profitability. Estimates for 2020 moved 0.4% south over the past seven days, reflecting analysts' concern over earnings growth potential. Yet, its focus on improving customer experience through e-commerce is encouraging.

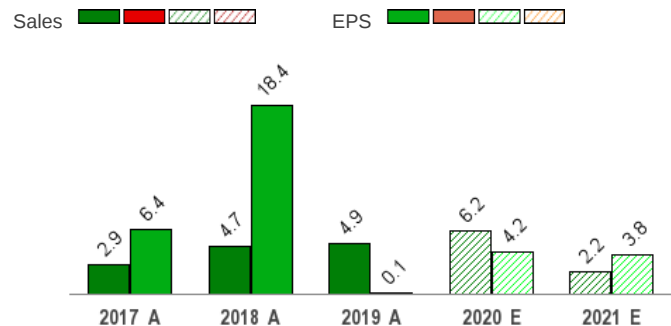
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$183.00 - \$136.45
20 Day Average Volume (sh)	204,703
Market Cap	\$6.3 B
YTD Price Change	-8.1%
Beta	0.85
Dividend / Div Yld	\$6.40 / 3.9%
Industry	Building Products - Air Conditioner and Heating
Zacks Industry Rank	Bottom 31% (176 out of 255)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	-8.9%
Last Sales Surprise	-0.9%
EPS F1 Est- 4 week change	-3.3%
Expected Report Date	04/28/2020
Earnings ESP	0.0%
P/E TTM	25.9
P/E F1	24.5
PEG F1	2.0
P/S TTM	1.3

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021					5,179 E
2020	1,024 E	1,481 E	1,455 E	1,104 E	5,068 E
2019	931 A	1,372 A	1,395 A	1,072 A	4,770 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$1.06 E	\$2.60 E	\$2.36 E	\$0.95 E	\$7.03 E
2020	\$0.90 E	\$2.54 E	\$2.34 E	\$0.94 E	\$6.77 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 02/24/2020. The reports text is as of 02/25/2020.

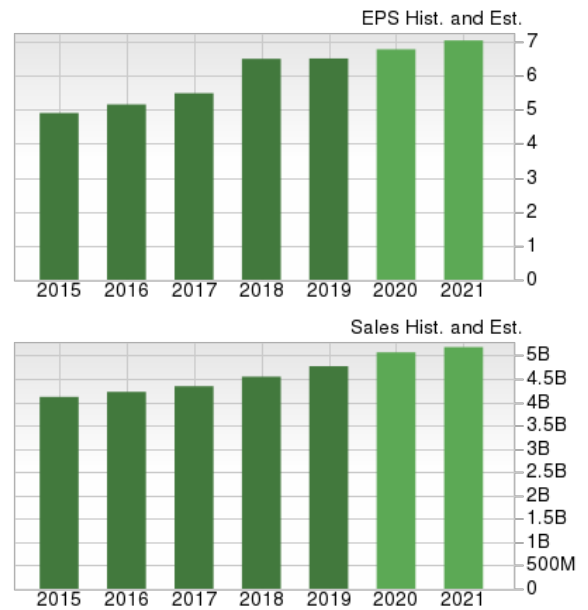
Overview

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 68% to 2019 revenues, Other HVAC products accounted for 28% 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 in 2019 grew 17% from the 2018 level to \$1.4 billion. E-commerce transactions also increased 20% year over year to more than 1 million.

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

In 2019, the number of unique iOS or Android app weekly users increased 60% from 2018.

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 investments over the next few months.

▲ **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 Feb 13, 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.

▲ **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:

▼ **Lackluster Earnings Surprise Trend:** Watsco registered a negative earnings surprise in the fourth quarter of 2019. In fact, the company has dismal earnings and revenues surprise history. It missed the consensus mark for earnings in 15 of the last 18 quarters, owing to extreme weather conditions and certain incremental costs.

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

The company's top line also missed the consensus mark in 19 of the trailing 23 quarters, .

Shares of Watsco declined significantly post lackluster results in fourth-quarter 2019. In fact, its shares have declined 7% in the past three months against its industry's 2.4% fall. Estimates for 2020 moved 0.4% south over the past seven days, reflecting analysts' concern over earnings growth potential.

▼ **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. Moreover, the fiscal first quarter is the company's weakest period of the year on a seasonal basis.

▼ **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.

▼ **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 Q4 Earnings & Sales Lag Estimates, Margins Down

Watsco, Inc. reported lackluster results in fourth-quarter 2019, wherein both earnings and revenues missed the Zacks Consensus Estimate. Also, its bottom line declined on a year-over-year basis due to higher SG&A.

In a bid to impress investors, Watsco announced 11% increase in annual dividend to \$7.10 per share on each outstanding share of its common and Class B stock. The change will be reflected in its next quarterly dividend payment beginning in April 2020.

Quarter Ending **12/2019**

Report Date	Feb 13, 2020
Sales Surprise	-0.87%
EPS Surprise	-8.91%
Quarterly EPS	0.92
Annual EPS (TTM)	6.40

Inside the Numbers

Watsco reported quarterly earnings of 92 cents per share, missing the consensus estimate of \$1.01 by 8.9%. Also, the said metric declined 9.8% from the year-ago level of \$1.02 per share. Lower margins and continued costs associated with technology investments were partially offset by a lower tax rate in the quarter.

Total revenues of \$1.07 billion lagged the consensus mark of \$1.08 billion by 0.9% but increased 8.2% from the year-ago period. Sales grew 1% on a same-store basis. The upside stemmed from strong HVAC equipment business, partially offset by soft demand in a few markets served. Continued investment in the technologies designed to revolutionize its customer experience added to the positives.

Sales of HVAC equipment (heating, ventilating and air conditioning; comprising 67% of sales) were up 3%, and that of other HVAC products (29% of sales) increased 2% from the prior-year quarter. Also, sales from commercial refrigeration products (4% of sales) rose 4% in the quarter.

Operating Highlights

Cost of sales grew 9.5% from a year ago to \$811.8 million. Gross margin contracted 90 basis points (bps) to 24.3%.

SG&A expenses increased 10% year over year due to addition of 35 locations. In fact, SG&A expenses — as a percentage of sales — surged 30 bps year over year. Operating margin contracted 100 bps year over year to 4.9%.

Financial Operations

As of Dec 31, 2019, cash and cash equivalents were \$74.5 million compared with \$82.9 million at 2018-end. Cash from operations came in at \$335.8 million in 2019 compared with \$170.6 million a year ago.

2019 Highlights

Watsco's 2019 earnings came in at \$6.50 per share, lagging the consensus mark of \$6.52 by 0.3% but increasing 0.2% from 2018. Total revenues of \$4.77 billion also missed analysts' expectation by 0.2% but improved almost 5% year over year.

Gross margin contracted 30 bps to 24.3%. Operating margin declined 50 bps year over year to 7.7%.

Valuation

Watsco's shares are down 7.2% in the year-to-date period but up 20% over the trailing 12-month period. Stocks in the Zacks sub-industry are down 1.6% but and the Zacks Construction sector is up 1.4% in the year-to-date period. Over the past year, the Zacks sub-industry and sector are up 11.3% and 23.2%, respectively.

The S&P 500 index is up 0.4% in the year-to-date period and 17.1% in the past year.

The stock is currently trading at 24.33X forward 12-month earnings, which compares to 23.85X for the Zacks sub-industry, 15.85X for the Zacks sector and 18.44X 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 24.02X. Our Neutral recommendation indicates that the stock will perform in line with the market. Our \$174 price target reflects 25.51X 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	24.33	23.85	15.85	18.44
	5-Year High	30.45	27.61	18.86	19.34
	5-Year Low	18.86	19.22	10.71	15.18
	5-Year Median	24.02	23.85	15.96	17.47
P/S F12M	Current	1.24	1.44	1.92	3.39
	5-Year High	1.54	1.97	2.23	3.43
	5-Year Low	0.88	1.2	1.25	2.54
	5-Year Median	1.18	1.66	1.65	3
EV/EBITDA TTM	Current	19.74	17.93	19.58	12
	5-Year High	21.99	19.1	22.6	12.87
	5-Year Low	13.83	13.68	14.43	8.48
	5-Year Median	17.98	16.8	19.38	10.77

As of 02/24/2020

Industry Analysis Zacks Industry Rank: Bottom 31% (176 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
VGM Score	C	-	-	B	A	B
Market Cap	6.31 B	2.28 B	23.50 B	2.80 B	1.76 B	9.54 B
# of Analysts	8	2	13	1	2	17
Dividend Yield	3.86%	0.71%	1.83%	0.60%	0.83%	1.25%
Value Score	D	-	-	F	A	C
Cash/Price	0.01	0.01	0.04	0.01	0.02	0.00
EV/EBITDA	16.61	16.61	13.56	37.66	10.34	16.73
PEG Ratio	1.95	1.07	2.02	NA	NA	1.07
Price/Book (P/B)	3.68	3.42	3.20	10.02	3.16	NA
Price/Cash Flow (P/CF)	18.79	18.64	13.05	46.49	11.44	18.64
P/E (F1)	24.36	21.46	18.56	41.67	14.44	21.46
Price/Sales (P/S)	1.32	1.39	2.60	6.10	0.71	2.51
Earnings Yield	4.09%	4.66%	5.38%	2.40%	6.94%	4.66%
Debt/Equity	0.18	0.07	0.70	0.00	0.54	-5.76
Cash Flow (\$/share)	8.81	4.20	7.03	1.16	4.20	13.26
Growth Score	A	-	-	A	A	A
Hist. EPS Growth (3-5 yrs)	8.40%	14.88%	10.85%	2.62%	35.57%	21.37%
Proj. EPS Growth (F1/F0)	4.14%	15.25%	6.90%	30.30%	15.25%	2.93%
Curr. Cash Flow Growth	26.69%	26.69%	6.78%	-7.54%	49.41%	13.08%
Hist. Cash Flow Growth (3-5 yrs)	16.29%	16.29%	8.38%	4.20%	28.42%	13.28%
Current Ratio	3.35	2.30	1.22	3.16	1.30	1.12
Debt/Capital	15.31%	11.10%	42.37%	0.00%	35.08%	NA
Net Margin	5.16%	5.16%	11.57%	10.94%	4.24%	10.73%
Return on Equity	14.68%	14.68%	16.80%	19.11%	20.05%	-202.30%
Sales/Assets	1.86	1.86	0.55	1.39	1.97	1.75
Proj. Sales Growth (F1/F0)	6.24%	5.87%	4.03%	NA	5.87%	5.51%
Momentum Score	F	-	-	A	C	F
Daily Price Chg	-1.69%	-0.85%	-2.98%	-2.69%	-1.72%	0.07%
1 Week Price Chg	-2.23%	-0.02%	-0.94%	-3.21%	-0.61%	0.92%
4 Week Price Chg	-6.58%	-0.77%	-0.94%	0.67%	-1.54%	3.80%
12 Week Price Chg	-6.03%	-4.67%	1.75%	10.66%	-4.67%	-1.47%
52 Week Price Chg	14.45%	8.95%	10.97%	27.15%	-11.67%	-0.30%
20 Day Average Volume	204,703	60,558	2,001,782	110,144	184,950	321,732
(F1) EPS Est 1 week change	-0.48%	0.00%	0.00%	0.00%	0.00%	-0.18%
(F1) EPS Est 4 week change	-3.26%	0.00%	-0.05%	0.00%	0.00%	-0.73%
(F1) EPS Est 12 week change	-3.17%	0.00%	-0.21%	0.00%	0.00%	-1.91%
(Q1) EPS Est Mthly Chg	-7.51%	-7.51%	-0.49%	NA	NA	-14.86%

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	D
Growth Score	A
Momentum Score	F
VGM Score	C

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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