

Watsco Inc. (WSO)

\$226.41 (As of 07/28/20)

Price Target (6-12 Months): **\$260.00**

Long Term: 6-12 Months

Zacks Recommendation:

Outperform

(Since: 07/28/20)

Prior Recommendation: Neutral

Short Term: 1-3 Months

Zacks Rank: (1-5)

1-Strong Buy

Zacks Style Scores:

VGM:A

Value: C

Growth: A

Momentum: B

Summary

Watsco reported impressive second-quarter 2020 results, backed by a steady recovery of sales in May and double-digit sales growth in June. Notably, the e-commerce business is gaining traction in recent times owing to stay-at-home orders issued by the government. Watsco has been adjusting business per the needs of customers, reducing costs in affected markets and improving efficiency. Shares of Watsco have outperformed the industry so far this year. However, coronavirus-led shutdowns dented its quarterly performance. Earnings and sales declined 5.8% and 1.2% year over year, respectively. Operating margin, on a same-store basis, contracted 10 basis points (bps). E-commerce sales pace also reduced to 33% compared with 36% in the first quarter.

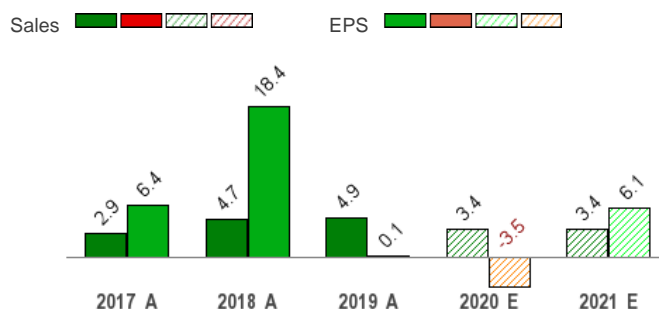
Price, Consensus & Surprise



Data Overview

52 Week High-Low	\$232.30 - \$132.97
20 Day Average Volume (sh)	266,101
Market Cap	\$8.7 B
YTD Price Change	25.7%
Beta	0.68
Dividend / Div Yld	\$7.10 / 3.1%
Industry	Building Products - Air Conditioner and Heating
Zacks Industry Rank	Top 30% (76 out of 253)

Sales and EPS Growth Rates (Y/Y %)



Last EPS Surprise	18.3%
Last Sales Surprise	4.0%
EPS F1 Est- 4 week change	13.8%
Expected Report Date	10/15/2020
Earnings ESP	0.0%
P/E TTM	37.1
P/E F1	36.1
PEG F1	2.9
P/S TTM	1.8

Sales Estimates (millions of \$)

	Q1	Q2	Q3	Q4	Annual*
2021	1,043 E	1,446 E	1,500 E	1,178 E	5,098 E
2020	1,008 A	1,355 A	1,484 E	1,101 E	4,931 E
2019	931 A	1,372 A	1,395 A	1,072 A	4,770 A

EPS Estimates

	Q1	Q2	Q3	Q4	Annual*
2021	\$0.75 E	\$2.37 E	\$2.54 E	\$0.98 E	\$6.65 E
2020	\$0.72 A	\$2.26 A	\$2.41 E	\$0.89 E	\$6.27 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 07/28/2020. The reports text is as of 07/29/2020.

Overview

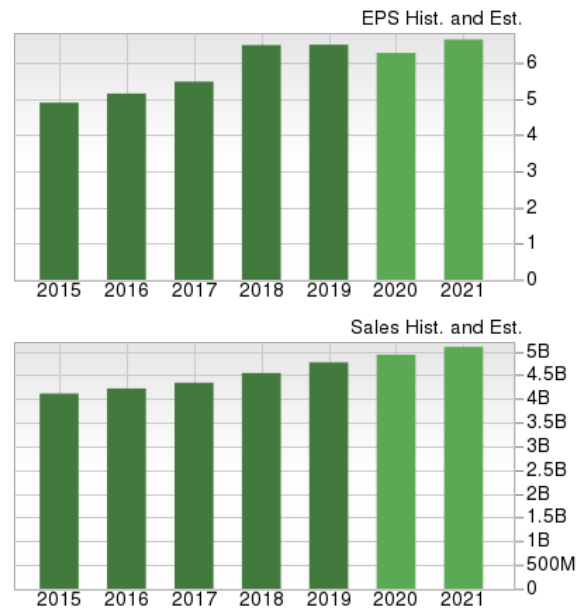
Incorporated in Florida in 1956, Watsco is the largest distributor of Heating, ventilation and air conditioning equipment, as well as related parts and supplies (HVAC/R) in North America. It distributes residential and commercial air conditioners; parts such as replacement compressors, evaporator coils 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 Jun 30, 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%.

Over the 12 months ended Jun 30, 2020, Watsco produced \$529 million of operating cash flow versus net income of \$285 million. Also, it repaid \$186 million of debt and increased dividends by 11% to an annual rate of \$7.10 per share.



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 \$1.5 billion products in the past 12 months as of Jun 30. Current run rate for e-commerce sales stands at 33% in second quarter compared with 29% at 2019-end. Transactions also increased 12% from a year ago.

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

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 34% from a year ago to more than 22,000 in second quarter.

Watsco's digital sales platform for HVAC/R contractors — OnCall Air — generated \$107 million in gross merchandise value for customers in second-quarter 2020, reflecting a 66% year-over-year increase. Also, its companion financing platform — CreditForComfort — processed almost 2,000 retail financing transactions, up 170% from the last year.

Business intelligence and data analytics expertise will aid insightful assistance and decision-making by managers. 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 \$3 billion, more than net income of roughly \$2.7 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 reduced long-term debt (which includes borrowings under the revolving credit agreement and operating lease liabilities) to \$190.6 million in the second quarter from \$308 million at first quarter-end and \$310 million at 2019-end.

The company ended the second quarter with cash and cash equivalents of \$79.6 million, higher than \$51.2 million in the last reported quarter and \$74.5 million at 2019-end. Its current cash level is sufficient to meet the short-term obligation of \$69.8 million. Notably, the company generated historically highest cash flow during the second quarter.

Its debt to capital at June-end was just 2% compared with 9% at first quarter-end.

Risks

- **Lackluster Year-Over-Year Performance:** Watsco has been delivering negative earnings surprise over the past few quarters. Discouragingly, it missed the consensus mark for earnings in 11 of the last 15 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 21 of the trailing 28 quarters.

Moreover, its earnings declined nearly 10% year over year in the first half of 2020. Lower revenues due to soft demand in a few international markets served and coronavirus-led shutdown, and reduced margins due to higher costs and expenses affected the results.

Although the e-commerce business is gaining traction in recent times owing to stay-at-home orders given by the government, the sales pace of the same registered a decline of 3 percentage points sequentially in second quarter. 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.

Historically, demand for the residential central air conditioning replacement market is comparatively low during first and fourth quarters. Similarly, demand for its heating equipment is generally impacted in the second and third quarters.

- **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.

Last Earnings Report

Watsco Q2 Earnings & Revenue Beat Estimates

Watsco, Inc. reported impressive second-quarter 2020 results, wherein earnings and revenues beat the respective Zacks Consensus Estimate. A steady recovery of sales in May and double-digit sales growth in June helped it deliver a better-than-expected performance.

Given the current market conditions, the company has been adjusting business per the needs of customers, reducing costs in affected markets and improving efficiency. It believes that financial strength, backed by highly-conservative leverage ratios, access to low-cost capital and ability to generate cash flow, allows it to take advantage of investment opportunities of almost any value.

Quarter Ending **06/2020**

Report Date	Jul 23, 2020
Sales Surprise	3.96%
EPS Surprise	18.32%
Quarterly EPS	2.26
Annual EPS (TTM)	6.10

Inside the Numbers

Watsco's quarterly earnings of \$2.26 per share topped the consensus estimate of \$1.91 by 18.3%. The reported earnings, however, declined 5.8% year over year.

Total revenues of \$1.36 billion surpassed the consensus mark of \$1.3 billion by 4% but decreased 1.2% from the year-ago period. Sales were down 6% on a same-store basis.

Sales of HVAC equipment (heating, ventilating and air conditioning; comprising 70% of sales) were down 4% year over year, including flat sales in U.S. residential markets. Sales of other HVAC products (27% of sales) also decreased 9% from the prior-year quarter. Sales from commercial refrigeration products (3% of sales) were down 15% year over year.

Operating Highlights

Gross margin contracted 30 basis points (bps) in the quarter. SG&A expenses improved 1% year over year. On a same-store basis, SG&A expenses — as a percentage of sales — improved 20 bps year over year as Watsco had a few store closings and loss of business across its network. Operating margin, on a same-store basis, contracted 10 bps year over year to 9.7%.

Financial Operations

As of Jun 30, 2020, cash and cash equivalents were \$79.6 million compared with \$74.5 million at 2019-end. Cash from operations came in at \$261.3 million in the first six months of 2020 compared with \$68.4 million in the comparable year-ago period.

Over the 12 months ended Jun 30, 2020, Watsco produced \$529 million of operating cash flow versus net income of \$285 million, repaid \$186 million in debt and increased dividends by 11% to an annual rate of \$7.10 per share.

Valuation

Watsco's shares are up 25.7% in the year-to-date period and 37.1% over the trailing 12-month period. Stocks in the Zacks sub-industry and the Zacks Construction sector are up 18.2% and 0.8% in the year-to-date period, respectively. Over the past year, the Zacks sub-industry and sector is up 22.1% and 12%, respectively.

The S&P 500 index is up 0.1% in the year-to-date period and 7.2% in the past year.

The stock is currently trading at 38.62X forward 12-month earnings, which compares to 35.09X for the Zacks sub-industry, 19.24X for the Zacks sector and 22.46X for the S&P 500 index.

Over the past five years, the stock has traded as high as 39.44X and as low as 18.86X, with a 5-year median of 24.4X. Our Outperform recommendation indicates that the stock will perform better than the market. Our \$260 price target reflects 44.37X 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	38.62	35.09	19.24	22.46
	5-Year High	39.44	35.09	19.24	22.46
	5-Year Low	18.86	19.42	10.74	15.25
	5-Year Median	24.4	24.09	15.86	17.52
P/S F12M	Current	1.8	1.4	2.06	3.54
	5-Year High	1.83	2.01	2.12	3.54
	5-Year Low	0.88	1.17	1.17	2.53
	5-Year Median	1.21	1.71	1.63	3.02
EV/EBITDA TTM	Current	27.45	21.82	18.48	11.95
	5-Year High	27.88	21.82	21.24	12.85
	5-Year Low	13.62	13.87	12.43	8.25
	5-Year Median	18.38	17.71	17.85	10.88

As of 07/28/2020

Industry Analysis Zacks Industry Rank: Top 30% (76 out of 253)



Top Peers

Company (Ticker)	Rec	Rank
Chart Industries, Inc. (GTLS)	Outperform	1
AAON, Inc. (AAON)	Neutral	3
Colfax Corporation (CFX)	Neutral	3
Comfort Systems USA, Inc. (FIX)	Neutral	3
HD Supply Holdings, Inc. (HDS)	Neutral	3
Hudson Technologies, Inc. (HDSN)	Neutral	3
Lennox International, Inc. (LII)	Neutral	3
Tecogen Inc. (TGEN)	Neutral	4

Industry Comparison Industry: Building Products - Air Conditioner And Heating				Industry Peers		
	WSO	X Industry	S&P 500	AAON	FIX	LII
Zacks Recommendation (Long Term)	Outperform	-	-	Neutral	Neutral	Neutral
Zacks Rank (Short Term)	1	-	-	3	3	3
VGM Score	A	-	-	B	A	A
Market Cap	8.68 B	2.36 B	22.47 B	2.97 B	1.75 B	10.36 B
# of Analysts	7	1	14	1	2	17
Dividend Yield	3.14%	0.77%	1.84%	0.67%	0.88%	1.14%
Value Score	C	-	-	D	B	C
Cash/Price	0.01	0.02	0.07	0.02	0.09	0.00
EV/EBITDA	22.47	18.34	13.04	32.47	9.49	18.34
PEG Ratio	2.89	NA	2.97	NA	NA	NA
Price/Book (P/B)	5.00	3.98	3.11	9.69	2.95	NA
Price/Cash Flow (P/CF)	31.89	20.43	12.07	38.85	10.78	20.43
P/E (F1)	36.11	33.96	21.52	43.54	20.34	31.84
Price/Sales (P/S)	1.80	1.80	2.35	6.02	0.61	2.89
Earnings Yield	2.77%	2.77%	4.34%	2.30%	4.92%	3.14%
Debt/Equity	0.11	0.07	0.76	0.00	0.68	-5.13
Cash Flow (\$/share)	7.10	4.45	7.01	1.47	4.45	13.26
Growth Score	A	-	-	A	A	A
Hist. EPS Growth (3-5 yrs)	7.33%	12.27%	10.85%	3.86%	26.39%	17.21%
Proj. EPS Growth (F1/F0)	-3.47%	-18.20%	-7.56%	28.43%	-21.33%	-23.94%
Curr. Cash Flow Growth	2.05%	2.05%	5.47%	26.97%	4.71%	13.08%
Hist. Cash Flow Growth (3-5 yrs)	11.37%	12.33%	8.55%	5.45%	31.42%	13.28%
Current Ratio	2.55	2.15	1.31	3.07	1.47	1.30
Debt/Capital	9.89%	8.13%	44.41%	0.00%	40.49%	NA
Net Margin	4.77%	4.77%	10.44%	13.37%	4.44%	9.53%
Return on Equity	13.38%	13.38%	15.10%	23.12%	21.52%	-145.33%
Sales/Assets	1.85	1.85	0.54	1.35	1.88	1.69
Proj. Sales Growth (F1/F0)	3.37%	0.00%	-1.97%	0.00%	12.08%	-9.32%
Momentum Score	B	-	-	B	D	A
Daily Price Chg	-0.94%	-0.06%	-0.80%	-1.52%	11.60%	-0.39%
1 Week Price Chg	17.19%	3.62%	0.37%	-0.79%	-1.93%	7.24%
4 Week Price Chg	27.41%	13.79%	3.64%	5.07%	17.79%	16.29%
12 Week Price Chg	38.88%	31.27%	11.56%	23.65%	43.88%	42.06%
52 Week Price Chg	37.18%	7.42%	-3.92%	10.52%	12.23%	4.32%
20 Day Average Volume	266,101	101,906	1,867,919	188,931	225,824	345,031
(F1) EPS Est 1 week change	13.97%	0.00%	0.00%	0.00%	0.00%	0.02%
(F1) EPS Est 4 week change	13.82%	0.00%	0.21%	0.00%	0.00%	8.12%
(F1) EPS Est 12 week change	17.78%	-10.27%	-1.29%	-10.27%	-28.81%	9.54%
(Q1) EPS Est Mthly Chg	27.65%	6.86%	0.09%	NA	0.00%	13.72%

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	A
Momentum Score	B
VGM Score	A

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.