WATSCO INC
Form 10-Q
May 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant To Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the Quarterly Period Ended March 31, 2006

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

Coconut Grove, 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 x NO ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Securities Exchange Act of 1934. Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ¨ NO x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 24,012,274 shares of Common Stock ($.50 par value), excluding treasury shares of 5,904,050 and 3,850,549 shares of Class B Common Stock ($.50 par value), excluding treasury shares of 48,263, were outstanding as of May 2, 2006.

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PART I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statements

WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except per share data)

(Unaudited)

	Quarter Ended March 31, 2006	2005
Revenues	$ 394,307	$ 345,952
Cost of sales	294,227	258,527
Gross profit	100,080	87,425
Selling, general and administrative expenses	78,238	71,616
Operating income	21,842	15,809
Interest expense, net	799	1,045
Income before income taxes	21,043	14,764
Income taxes	7,996	5,616
Net income	$ 13,047	$ 9,148
Earnings per share for Common and Class B common stock:		
Basic	$ 0.50	$ 0.35
Diluted	$ 0.47	$ 0.33
Weighted average Common and Class B common shares and equivalent shares used to calculate earnings per share:		
Basic	26,121	25,935
Diluted	27,984	27,554

See accompanying notes to condensed consolidated financial statements.

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WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands)

	March 31, 2006 (Unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 675	$ 27,650
Accounts receivable, net	186,704	191,747
Inventories	316,718	266,543
Other current assets	13,404	8,051
Total current assets	517,501	493,991
Property and equipment, net	17,532	17,244
Goodwill and intangibles, net	164,208	163,686
Other assets	4,035	3,810
	$ 703,276	$ 678,731
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	$ 10,080	$ 10,079
Accounts payable	128,333	100,829
Accrued expenses and other current liabilities	36,715	68,390
Total current liabilities	175,128	179,298
Long-term obligations:		
Borrowings under revolving credit agreement	35,000	30,000
Long-term notes, net of current portion	10,000	10,000
Other long-term obligations, net of current portion	176	189
Total long-term obligations	45,176	40,189
Deferred income taxes and other liabilities	9,202	8,594
Commitments and contingencies (Note 9)		
Shareholders equity:		
Common stock, $.50 par value	14,956	14,931
Class B common stock, $.50 par value	1,949	1,696
Paid-in capital	247,774	264,903
Deferred compensation on non-vested stock		(35,894)
Accumulated other comprehensive loss, net of tax	(296)	(478)
Retained earnings	297,933	290,383
Treasury stock, at cost	(88,546)	(84,891)
Total shareholders equity	473,770	450,650

	$ 703,276	$ 678,731

See accompanying notes to condensed consolidated financial statements.

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WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Quarter Ended March 31, 2006	2005
Cash flows from operating activities:		
Net income	$ 13,047	$ 9,148
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	1,435	1,467
Share-based compensation	1,109	476
Tax benefits from share-based compensation		1,193
Excess tax benefits from share-based compensation	(7,980)	
Provision for doubtful accounts	414	767
Other, net	1,937	898
Changes in assets and liabilities, net of effects of acquisitions:		
Accounts receivable	5,112	(4,312)
Inventories	(48,790)	(14,984)
Accounts payable and other liabilities	8,957	(24,737)
Other, net	(5,575)	41
Net cash used in operating activities	(30,334)	(30,043)
Cash flows from investing activities:		
Capital expenditures	(1,685)	(1,593)
Business acquisitions, net of cash acquired	(1,260)	(49,672)
Proceeds from sale of property and equipment	42	49
Net cash used in investing activities	(2,903)	(51,216)
Cash flows from financing activities:		
Excess tax benefits from share-based compensation	7,980	
Net borrowings under revolving credit agreement	5,000	5,000
Net proceeds from issuances of common stock	2,448	1,577
Net repayments of other long-term obligations	(12)	(11)
Purchase of treasury stock	(3,655)	
Common and Class B common stock dividends	(5,499)	(3,786)
Net cash provided by financing activities	6,262	2,780
Net decrease in cash and cash equivalents	(26,975)	(78,479)
Cash and cash equivalents at beginning of period	27,650	85,144
Cash and cash equivalents at end of period	$ 675	$ 6,665

See accompanying notes to condensed consolidated financial statements.

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WATSCO, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2006

(In thousands, except share and per share data)

(Unaudited)

1. Basis of Presentation

Basis of Consolidation

The accompanying condensed consolidated balance sheet as of December 31, 2005, which has been derived from Watsco, Inc. and its subsidiaries (collectively, Watsco, which may be referred to as *we*, *us* or *our*) audited consolidated financial statements, and the March 31, 2006 unaudited interim condensed consolidated financial statements, have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and note disclosures normally included in the annual financial statements prepared in accordance with U.S. generally accepted accounting principles 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 only normal recurring adjustments, necessary for a fair presentation have been included in the condensed consolidated financial statements herein. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in the December 31, 2005 Annual Report on Form 10-K. All amounts, except share and per share data, are expressed in thousands of dollars.

The results of operations for the quarter ended March 31, 2006, are not necessarily indicative of the results to be expected for the year ending December 31, 2006. Sales of residential central air conditioners, heating equipment and parts and supplies distributed by Watsco have historically been seasonal with revenues generally increasing during the months of May through August. Demand related to the residential central air conditioning replacement market is highest in the second and third quarters with demand for heating equipment usually highest in the fourth quarter.

Use of Estimates

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles 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 financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include valuation reserves for accounts receivable, inventory and income taxes, reserves for self-insurance programs and valuation of goodwill. Actual results could differ from those estimates.

Reclassifications

Certain reclassifications have been made to prior period condensed consolidated financial statements to conform to the current period presentation. These reclassifications had no effect on net income or earnings per share as previously reported.

Accounting Change

At March 31, 2006, we had two share-based compensation plans for employees, which are described more fully in Note 2. Prior to January 1, 2006, we accounted for those plans in accordance with the recognition and measurement provisions of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related Interpretations, as permitted by Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation. Prior to January 1, 2006, share-based compensation was recognized only for grants of non-vested (restricted) stock and share-based compensation expense was not recognized for stock options. Effective January 1, 2006, we adopted the provisions of SFAS No. 123R, Share-Based Payment, using the modified prospective transition method. Under this transition method, compensation expense recognized during the quarter ended March 31, 2006 included: (a) compensation expense for all share-based awards granted prior to, but not yet vested as of January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS No. 123 and (b) compensation expense for all share-based awards granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS No. 123R. Results for prior periods have not been restated.

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As a result of adopting SFAS No. 123R on January 1, 2006, income before income taxes and net income for the quarter ended March 31, 2006 were $288 and $179 lower, respectively, than if we had continued to account for share-based compensation under APB No. 25. Basic and diluted earnings per share for the quarter ended March 31, 2006 would have been $0.51 and $0.47, respectively, if we had not adopted SFAS No. 123R, compared to reported basic and diluted earnings per share of $0.50 and $0.47, respectively.

Prior to the adoption of SFAS No. 123R, we presented all tax benefits of deductions resulting from the exercise of stock options as operating cash flows in the condensed consolidated statements of cash flows. SFAS No. 123R requires the cash flows from the tax benefits resulting from tax deductions in excess of the compensation expense recognized for those options (excess tax benefits) to be classified as financing cash flows. The excess tax benefit of $7,980 classified as a financing cash inflow would have been classified as an operating cash inflow if we had not adopted SFAS No. 123R.

Prior to the adoption of SFAS No. 123R, the intrinsic value of our non-vested stock was recorded as deferred compensation as of December 31, 2005. Upon the adoption of SFAS No. 123R on January 1, 2006, the deferred compensation balance of $35,894 was reclassified to paid-in capital.

In accordance with the modified prospective transition method, results for the quarter ended March 31, 2005 have not been restated. Had compensation cost been determined based on the fair value method at the grant dates for awards under the stock-based compensation plans consistent with the method of SFAS No. 123, pro forma net income and earnings per share would be as follows for the quarter ended March 31, 2005:

	2005
Net income, as reported	$ 9,148
Share-based compensation expense included in net income, net of tax	295
Share-based compensation expense determined under the fair value-based method, net of tax	(774)
Net income, pro forma	$ 8,669
Basic earnings per share for Common and Class B common Stock:	
As reported	$ 0.35
Pro forma	$ 0.33
Diluted earnings per share for Common and Class B common Stock:	
As reported	$ 0.33
Pro forma	$ 0.31

2. Share-Based Compensation

Share-Based Compensation Plans

At March 31, 2006, we had two share-based compensation plans for employees. The 2001 Incentive Compensation Plan (the 2001 Plan) provides for the award of a broad variety of stock-based compensation alternatives such as non-qualified stock options, incentive stock options, non-vested (restricted) stock, performance awards, dividend equivalents, deferred stock and stock appreciation rights at no less than 100% of the market price on the date the award is granted. To date, awards under the 2001 Plan consist of non-qualified stock options and non-vested stock. Under the 2001 Plan, awards for an aggregate of 3,000,000 shares of Common and Class B common stock may be granted. Options under the 2001 Plan vest over two to five years of service and have contractual terms of five to ten years. Awards of non-vested stock, which are granted at no cost to the employee, vest upon attainment of a certain age, generally the employee s respective retirement age. We also maintain the 1991 Stock Option Plan (the 1991 Plan), which expired during 2001; therefore, no additional options may be granted. Options under the 1991 Plan vest over two to five years of service and have contractual terms of ten years.

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A summary of stock option activity under the 2001 Plan and 1991 Plan as of March 31, 2006, and changes during the quarter ended March 31, 2006, is as follows:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at January 1, 2006	2,589,363	$ 17.30		
Granted	52,500	66.31		
Exercised	(388,650)	15.76		
Forfeited	(4,000)	14.82		
Options outstanding at March 31, 2006	2,249,213	$ 18.71	4.0	$ 117,722
Options exercisable at March 31, 2006	1,691,896	$ 13.54	3.7	$ 97,309

The weighted-average grant date fair value of stock options granted during the quarters ended March 31, 2006 and 2005 was $16.38 and $10.67, respectively. The total intrinsic value of stock options exercised during the quarters ended March 31, 2006 and 2005 was $21,005 and $2,281, respectively. The fair value of stock options vested during the quarters ended March 31, 2006 and 2005 was $48 and $548, respectively.

A summary of non-vested stock issued as of March 31, 2006, and changes during the quarter ended March 31, 2006, is shown below:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested stock outstanding at January 1, 2006	1,593,561	$ 26.62
Granted	73,544	68.85
Vested		
Forfeited		
Non-vested stock outstanding at March 31, 2006	1,667,105	$ 28.48

The weighted-average grant date fair value of non-vested stock granted during the quarters ended March 31, 2006 and 2005 was $68.85 and $37.60, respectively. The fair value of stock vested during the quarter ended March 31, 2005 was $282. No non-vested stock vested during the quarter ended March 31, 2006.

Share-Based Compensation Fair Value Assumptions

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing valuation model based on the weighted-average assumptions noted in the table below. The fair value of the stock option awards, which are subject to graded vesting, is expensed on a straight-line basis over the vesting life of the stock options. Expected volatility is based on historical volatility of Watsco s stock. The risk-free rate for periods within the contractual life of the stock option award is based on the yield curve of a zero-coupon U.S. Treasury bond on the date the stock option award is granted with a maturity equal to the expected term of the stock option award. We use historical data to estimate stock option forfeitures within the valuation model. All of the awards granted during the quarter ended March 31, 2006 meet the definition of plain vanilla options, as defined in SEC Staff Accounting Bulletin No. 107. The expected term of stock option awards granted represents the period of time that stock option awards granted are expected to be outstanding and was calculated using the simplified method for plain vanilla options.

The weighted-average assumptions relating to the valuation of our stock options for the quarters ended March 31, 2006 and 2005 were as follows:

	2006	**2005**
Expected term in years	4.25	4.00
Risk-free rate	4.83%	4.07%
Expected volatility	23.85%	35.50%
Expected dividends	1.25%	1.40%

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Share-Based Compensation Expense