

WATSCO INC
Form 10-Q
August 06, 2010
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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 June 30, 2010

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)

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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 NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 28,073,588 shares of Common stock (\$.50 par value), excluding treasury shares of 6,322,650 and 4,326,326 shares of Class B common stock (\$.50 par value), excluding treasury shares of 48,263, were outstanding as of August 3, 2010.

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WATSCO, INC. AND SUBSIDIARIES

QUARTERLY REPORT ON FORM 10-Q

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WATSCO, INC. AND SUBSIDIARIES****CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF INCOME**

(In thousands, except per share data)

	Quarter Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Revenues	\$ 864,805	\$ 404,971	\$ 1,374,560	\$ 696,314
Cost of sales	663,736	303,986	1,050,887	521,095
Gross profit	201,069	100,985	323,673	175,219
Selling, general and administrative expenses	130,150	74,691	243,889	150,487
Operating income	70,919	26,294	79,784	24,732
Interest expense, net	894	344	1,791	672
Income before income taxes	70,025	25,950	77,993	24,060
Income taxes	21,818	9,668	24,311	8,950
Net income	48,207	16,282	53,682	15,110
Less: net income attributable to noncontrolling interest	13,162		14,804	
Net income attributable to Watsco, Inc.	\$ 35,045	\$ 16,282	\$ 38,878	\$ 15,110
Earnings per share for Common and Class B common stock:				
Basic	\$ 1.08	\$ 0.57	\$ 1.20	\$ 0.53
Diluted	\$ 1.08	\$ 0.56	\$ 1.20	\$ 0.52

See accompanying notes to condensed consolidated unaudited financial statements.

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WATSCO, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share data)

	June 30, 2010 (Unaudited)	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 87,757	\$ 58,093
Accounts receivable, net	385,532	266,284
Inventories	522,545	410,078
Other current assets	19,784	20,843
Total current assets	1,015,618	755,298
Property and equipment, net	31,361	33,118
Goodwill	304,154	303,257
Intangible assets	57,552	58,566
Other assets	8,883	10,374
	\$ 1,417,568	\$ 1,160,613
LIABILITIES AND SHAREHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term obligations	\$ 153	\$ 151
Accounts payable	344,842	145,825
Accrued expenses and other current liabilities	103,430	77,950
Total current liabilities	448,425	223,926
Long-term obligations:		
Borrowings under revolving credit agreements	20,000	12,763
Other long-term obligations, net of current portion	574	666
Total long-term obligations	20,574	13,429
Deferred income taxes and other liabilities	28,737	28,450
Commitments and contingencies (Note 8)		
Watsco, Inc. shareholders equity:		
Common stock, \$.50 par value	17,199	17,105
Class B common stock, \$.50 par value	2,191	2,150
Preferred stock, \$.50 par value		
Paid-in capital	468,159	461,563
Accumulated other comprehensive loss, net of tax	(757)	(821)
Retained earnings	378,994	372,454

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Treasury stock, at cost	(114,425)	(114,425)
Total Watsco, Inc. shareholders equity	751,361	738,026
Noncontrolling interest	168,471	156,782
Total shareholders equity	919,832	894,808
	\$ 1,417,568	\$ 1,160,613

See accompanying notes to condensed consolidated unaudited financial statements.

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WATSCO, INC. AND SUBSIDIARIES

CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF CASH FLOWS

Six Months Ended June 30, 2010 and 2009

(In thousands)

	2010	2009
Cash flows from operating activities:		
Net income	\$ 53,682	\$ 15,110
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	5,148	3,413
Share-based compensation	2,907	2,659
Provision for doubtful accounts	1,816	3,245
Gain on sale of property and equipment	(418)	(52)
Excess tax benefits from share-based compensation	(2,088)	(3,711)
Other, net	1,705	1,384
Changes in operating assets and liabilities, net of effects of acquisitions:		
Accounts receivable	(120,494)	(28,357)
Inventories	(109,173)	(15,205)
Accounts payable and other liabilities	221,543	48,174
Other, net	2,202	899
Net cash provided by operating activities	56,830	27,559
Cash flows from investing activities:		
Capital expenditures	(3,839)	(1,578)
Business acquisitions, net of cash acquired	(2,406)	
Proceeds from sale of property and equipment	2,073	148
Net cash used in investing activities	(4,172)	(1,430)
Cash flows from financing activities:		
Dividends on Common and Class B common stock	(32,338)	(26,451)
Distributions to noncontrolling interest	(3,115)	
Net repayments of other long-term obligations	(90)	(124)
Excess tax benefits from share-based compensation	2,088	3,711
Net proceeds from issuances of common stock	3,224	5,847
Net proceeds under revolving credit agreements	7,237	
Costs related to amendment of revolving credit agreement		(5,253)
Net cash used in financing activities	(22,994)	(22,270)
Net increase in cash and cash equivalents	29,664	3,859
Cash and cash equivalents at beginning of period	58,093	41,444
Cash and cash equivalents at end of period	\$ 87,757	\$ 45,303

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See accompanying notes to condensed consolidated unaudited financial statements.

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WATSCO, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

June 30, 2010

(In thousands, except share and per share data)

1. BASIS OF PRESENTATION

Basis of Consolidation

Watsco, Inc. and its subsidiaries (collectively, Watsco, which may be referred to as *we, us* or *our*) was incorporated in 1956 and is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies (HVAC/R) in the HVAC/R distribution industry. The accompanying Watsco June 30, 2010 interim condensed consolidated unaudited financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and note disclosures normally included in the annual financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) 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 normal and recurring adjustments, necessary for a fair presentation have been included in the condensed consolidated unaudited financial statements herein. These statements should be read in conjunction with the consolidated financial statements and notes thereto included in our 2009 Annual Report on Form 10-K.

The condensed consolidated unaudited financial statements contained in this report include the accounts of Watsco and all of its wholly-owned subsidiaries and effective July 1, 2009, include the accounts of a joint venture in which Watsco maintains a 60% controlling interest. See Note 6, Acquisitions. All significant intercompany balances and transactions have been eliminated.

The results of operations for the quarter and six months ended June 30, 2010 are not necessarily indicative of the results to be expected for the year ending December 31, 2010. Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on weather patterns during the summer and winter selling seasons. Demand related to the residential central air conditioning replacement market is highest in the second and third quarters, and demand for heating equipment is usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly consistent during the year except for dependence on housing completions and related weather and economic conditions.

Use of Estimates

The preparation of condensed consolidated unaudited financial statements in conformity with U.S. GAAP 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 unaudited 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 related to self-insurance programs and valuation of goodwill and indefinite lived intangible assets. While we believe that these estimates are reasonable, actual results could differ from such estimates.

Recently Adopted Accounting Standards

Transfers of Financial Assets

On January 1, 2010, we adopted a new accounting standard issued by the Financial Accounting Standards Board (FASB) that addresses the accounting and disclosure requirements for transfers of financial assets. The adoption of this guidance did not have a material impact on our condensed consolidated unaudited financial statements.

Variable Interest Entities

On January 1, 2010, we adopted accounting guidance issued by the FASB that amended the consolidation principles for variable interest entities (VIEs) by requiring consolidation of VIEs based on whether an entity has the power to direct the activities that most significantly impact the

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VIEs economic performance and shares in the significant risks and rewards of the entity. The adoption of this guidance did not have a material impact on our condensed consolidated unaudited financial statements.

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In October 2009, the FASB issued accounting guidance that amends the criteria for allocating a contract's consideration to individual services or products in multiple deliverable arrangements. This guidance is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. We will adopt this guidance beginning on January 1, 2011 and do not expect a material impact on our condensed consolidated unaudited financial statements.

2. EARNINGS PER SHARE

Earnings per share is computed using the two-class method. The two-class method of computing earnings per share is an earnings allocation formula that determines earnings per share for common stock and any participating securities according to dividends declared (whether paid or unpaid) and participation rights in undistributed earnings. Shares of our non-vested (restricted) stock are considered participating securities because these awards contain a non-forfeitable right to dividends irrespective of whether the awards ultimately vest. Under the two-class method, earnings per common share for our Common and Class B common stock is computed by dividing the sum of distributed earnings to common shareholders and undistributed earnings allocated to common shareholders by the weighted-average number of shares of Common stock and Class B common stock outstanding for the period. In applying the two-class method, undistributed earnings are allocated to Common stock, Class B common stock and participating securities based on the weighted-average shares outstanding during the period.

Diluted earnings per share of our Common stock assumes the conversion of all of our Class B common stock (2,866,881 and 2,575,364 shares as of June 30, 2010 and 2009, respectively) into Common stock as of the beginning of the period and adjusts for the dilutive effects of outstanding stock options using the treasury stock method.

The following table presents the calculation of basic and diluted earnings per common share for our Common and Class B common stock for the quarters and six months ended June 30, 2010 and 2009:

	Quarter Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
Basic Earnings per Share:				
Net income attributable to Watsco, Inc. shareholders	\$ 35,045	\$ 16,282	\$ 38,878	\$ 15,110
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	(2,100)	(992)	(2,342)	(944)
Earnings allocated to Watsco, Inc. shareholders	\$ 32,945	\$ 15,290	\$ 36,536	\$ 14,166
Allocation of earnings for Basic:				
Common stock	\$ 29,844	\$ 13,825	\$ 33,092	\$ 12,803
Class B common stock	3,101	1,465	3,444	1,363
	\$ 32,945	\$ 15,290	\$ 36,536	\$ 14,166
Diluted Earnings per Share:				
Net income attributable to Watsco, Inc. shareholders	\$ 35,045	\$ 16,282	\$ 38,878	\$ 15,110
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	(2,097)	(990)	(2,341)	(953)
Earnings allocated to Watsco, Inc. shareholders	\$ 32,948	\$ 15,292	\$ 36,537	\$ 14,157

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The diluted earnings per share calculation assumes the conversion of all of our Class B common stock into Common stock as of the beginning of the period; therefore, no allocation of earnings to Class B common stock is required.

Weighted-average Common and Class B common shares outstanding for basic earnings per share	30,461,079	26,876,952	30,413,994	26,775,500
Effect of dilutive stock options	108,445	373,264	123,142	381,348
Weighted-average Common and Class B common shares outstanding for diluted earnings per share	30,569,524	27,250,216	30,537,136	27,156,848

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Diluted earnings per share excluded 84,000 and 227,681 shares for the quarters ended June 30, 2010 and 2009, respectively, and 117,561 and 263,152 shares for the six months ended June 30, 2010 and 2009, respectively, related to stock options with an exercise price per share greater than the average market value, resulting in an anti-dilutive effect on diluted earnings per share.

3. DERIVATIVE FINANCIAL INSTRUMENTS

Periodically, we enter into interest rate swap agreements to reduce our exposure to market risk from changing interest rates under our revolving credit agreements. Under the terms of the swap agreements, we agree to exchange, at specified intervals, the difference between fixed and variable interest amounts calculated by reference to the notional principal amount. Any differences paid or received on our interest rate swap agreements are recognized as adjustments to interest expense over the life of each swap, thereby adjusting the effective interest rate on the underlying obligation. Financial instruments are not held or issued for trading purposes. In order to obtain hedge accounting treatment, any derivatives used for hedging purposes must be designated as, and effective as, a hedge of an identified risk exposure at the inception of the contract. Changes in the fair value of the derivative contract must be highly correlated with changes in the fair value of the underlying hedged item at inception of the hedge and over the life of the hedge contract. Accordingly, we record all derivative instruments as either assets or liabilities on the condensed consolidated balance sheets at their respective fair values. We record the change in the fair value of a derivative instrument designated as a cash flow hedge in other comprehensive income to the extent the derivative is effective, and recognize the change in the statement of income when the hedged item affects earnings. Our interest rate hedge is designated as a cash flow hedge.

At both June 30, 2010 and December 31, 2009, we had one interest rate swap agreement was in effect with a notional value of \$10,000, maturing in October 2011. The swap agreement exchanges the variable rate of 30-day LIBOR to a fixed interest rate of 5.07%. During the quarter and six months ended June 30, 2010 and 2009, the hedging relationship was determined to be highly effective in achieving offsetting changes in cash flows.

We were party to an interest rate swap agreement with a notional amount of \$10,000, which matured on October 31, 2009, that was designated as a cash flow hedge and effectively exchanged the variable rate of 30-day LIBOR to a fixed interest rate of 5.04%. During the quarter and six months ended June 30, 2009, the hedging relationship was determined to be highly effective in achieving offsetting changes in cash flows.

The negative fair value of the derivative financial instrument was \$602 and \$710 at June 30, 2010 and December 31, 2009, respectively, and is included, net of accrued interest, in deferred income taxes and other liabilities in the condensed consolidated balance sheets. See Note 4, Fair Value Measurements. At June 30, 2010 and December 31, 2009, \$364, net of deferred tax benefits of \$223 and \$432, net of deferred tax benefits of \$262, respectively, was included in accumulated other comprehensive loss (OCL) associated with the cash flow hedge.

The net change in OCL for the quarters and six months ended June 30, 2010 and 2009, reflected the reclassification of \$75, net of income tax benefit of \$46, \$148, net of income tax benefit of \$88, \$150, net of income tax benefit of \$92 and \$293, net of income tax benefit of \$173, respectively, of unrealized losses from accumulated OCL to current period earnings (recorded in interest expense, net in the condensed consolidated unaudited statements of income). The net unrealized loss recorded in accumulated OCL will be reclassified to earnings on a monthly basis as interest payments occur. We estimate that approximately \$450 in unrealized losses on the derivative instrument accumulated in OCL are expected to be reclassified to earnings during the next twelve months using a current 30-day LIBOR-based average receive rate (0.55% at June 30, 2010). See Note 5, Comprehensive Income.

4. FAIR VALUE MEASUREMENTS

We carry various assets and liabilities at fair value in the condensed consolidated balance sheets. Fair value is defined as an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. Fair value measurements are classified based on the following fair value hierarchy:

Level 1 Quoted prices in active markets for identical assets or liabilities. An active market for an asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.

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Level 2 Observable inputs other than Level 1 prices such as quoted prices in active markets for similar assets or liabilities; quoted prices in markets that are not active; or model-driven valuations or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 Unobservable inputs for the asset or liability. These inputs reflect our own assumptions about the assumptions a market participant would use in pricing the asset or liability.

The following table presents our assets and liabilities that are measured at fair value on a recurring basis and the levels of inputs used to measure fair value:

Description	Fair Value at June 30, 2010	Fair Value Measurements at June 30, 2010 Using		
		Level 1	Level 2	Level 3
Assets:				
Available-for-sale securities	\$ 95	\$ 95		
Liabilities:				
Derivative financial instrument	\$ 602		\$ 602	

Description	Fair Value at December 31, 2009	Fair Value Measurements at December 31, 2009 Using		
		Level 1	Level 2	Level 3
Assets:				
Available-for-sale securities	\$ 104	\$ 104		
Liabilities:				
Derivative financial instrument	\$ 710		\$ 710	

The following is a description of the valuation techniques used for these assets and liabilities, as well as the level of input used to measure fair value:

Available-for-sale securities the investments are exchange-traded equity securities. Fair values for these investments are based on quoted prices in active markets and are therefore classified within Level 1 of the fair value hierarchy.

Derivative financial instrument the derivative is a pay-variable, receive fixed interest rate swap based on 30-day LIBOR. Fair value is based on model-derived valuations using the respective LIBOR rate, which is observed at quoted intervals for the full term of the swap and incorporates adjustments to appropriately reflect our nonperformance risk and the counterparty's nonperformance risk. Therefore, the derivative is classified within Level 2 of the fair value hierarchy. See Note 3, Derivative Financial Instruments, for further information.

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Comprehensive income consists of net income and changes in the unrealized losses on available-for-sale securities and the effective portion of cash flow hedges as further discussed in Note 3, Derivative Financial Instruments. The components of comprehensive income for the quarters and six months ended June 30, 2010 and 2009, respectively, are as follows:

	Quarter Ended		Six Months Ended	
	June 30,		June 30,	
	2010	2009	2010	2009
Net income	\$ 48,207	\$ 16,282	\$ 53,682	\$ 15,110
Changes in unrealized losses on derivative instruments, net of income tax expense of \$29, \$70, \$40 and \$115, respectively	47	114	68	204
Changes in unrealized losses on available-for-sale securities, net of income tax (expense) benefit of \$10, \$(16), \$5 and \$31, respectively	(14)	27	(4)	(44)
Comprehensive income	48,240	16,423	53,746	15,270
Less: comprehensive income attributable to noncontrolling interest	13,162		14,804	
Comprehensive income attributable to Watsco, Inc.	\$ 35,078	\$ 16,423	\$ 38,942	\$ 15,270

6. ACQUISITIONS

On July 1, 2009, we completed the formation of a joint venture with Carrier Corporation (Carrier) to distribute Carrier, Bryant and Payne products throughout the U.S. Sunbelt, Latin America and the Caribbean. The joint venture, Carrier Enterprise, LLC (Carrier Enterprise), operates 110 locations in 20 states and Puerto Rico and serves over 19,000 air conditioning and heating contractors. In the formation of the joint venture, Carrier contributed 95 locations in the U.S. Sunbelt and Puerto Rico and the export division located in Miami, Florida and we contributed 15 locations that distributed Carrier, Bryant and Payne products. The results of operations of the new Carrier Enterprise locations have been included in the condensed consolidated unaudited financial statements from the date of acquisition.

The unaudited pro forma financial information combining our results of operations with the operations of Carrier Enterprise as if the joint venture had been consummated on January 1, 2009 is as follows:

	Quarter Ended	Six Months Ended
	June 30,	June 30,
	2009	2009
Revenues	\$ 740,189	\$ 1,256,818
Net income	27,947	23,349
Less: net income attributable to noncontrolling interest	6,600	5,084
Net income attributable to Watsco, Inc.	\$ 21,347	\$ 18,265
Diluted earnings per share for Common and Class B common shares	\$ 0.67	\$ 0.55

This unaudited pro forma financial information is presented for informational purposes only. The unaudited pro forma financial information from the beginning of the period presented until the acquisition date includes adjustments to record income taxes related to our portion of Carrier Enterprise's income, amortization of bank fees paid to amend our existing \$300,000 revolving credit agreement entered into upon the consummation of the joint venture, amortization of bank fees paid by Carrier Enterprise to enter into a separate secured three-year \$75,000 revolving credit agreement and amortization related to identified intangible assets with finite lives and does not include adjustments to remove certain corporate expenses of Carrier Enterprise, which may not be incurred in future periods, adjustments for depreciation, or synergies

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(primarily related to improved gross profit and lower general and administrative expenses) that may be realized subsequent to the acquisition date. The unaudited pro forma financial information is not necessarily indicative of our future results of operations or what the results of operations would have been had we owned and operated Carrier Enterprise as of the beginning of the period presented.

In April 2010, one of our subsidiaries acquired certain assets and assumed certain liabilities of a wholesale distributor of air conditioning and heating products operating from two locations in Tennessee. The purchase price of the acquisition included a cash payment of approximately \$2,400.

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The results of operations of these acquired locations have been included in the condensed consolidated unaudited financial statements from their respective dates of acquisition. The pro forma effect of the April 2010 acquisition was not deemed significant to the condensed consolidated unaudited financial statements.

7. SHAREHOLDERS EQUITY**Dividends Declared**

Our Board of Directors declared cash dividends on Common and Class B common stock of \$0.52 per share, \$0.48 per share, \$1.00 per share and \$0.93 per share for the quarters and six months ended June 30, 2010 and 2009, respectively. On July 1, 2010, our Board of Directors declared a regular quarterly cash dividend of \$0.52 per share of Common and Class B common stock that was paid on July 30, 2010 to shareholders of record as of July 15, 2010.

Non-Vested (Restricted) Stock

No shares of non-vested (restricted) stock were granted during the quarter ended June 30, 2010. During the six months ended June 30, 2010, we granted 132,500 shares of non-vested (restricted) stock. No shares of non-vested (restricted) stock were granted during the quarter or six months ended June 30, 2009. During the quarters ended June 30, 2010 and 2009, 258 shares of Common stock with an aggregate market value of \$16 and 601 shares of Common stock with an aggregate market value of \$24, respectively, were delivered as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of non-vested (restricted) stock. During the six months ended June 30, 2010 and 2009, 5,111 shares of Common stock with an aggregate market value of \$293 and 601 shares of Common stock with an aggregate market value of \$24, respectively, were delivered as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of non-vested (restricted) stock. These shares were retired upon delivery.

Stock Options

During the quarters ended June 30, 2010 and 2009, 13,000 and 152,550, respectively, of stock options were exercised for Common stock. During the six months ended June 30, 2010 and 2009, 174,850 and 420,050, respectively, of stock options were exercised for Common and Class B common stock. Cash received from Common and Class B common stock issued as a result of stock options exercised during the quarters and six months ended June 30, 2010 and 2009, was \$366, \$3,226, \$2,808 and \$5,422, respectively. During the six months ended June 30, 2010 and 2009, 48,938 shares of Class B common stock with an aggregate market value of \$2,814 and 91,942 shares of common stock with an aggregate market value of \$3,333, respectively, were delivered as payment in lieu of cash for stock option exercises and related tax withholdings. These shares were retired upon delivery.

Employee Stock Purchase Plan

During the quarters ended June 30, 2010 and 2009, 3,864 and 6,918, shares of Common stock were issued under our employee stock purchase plan, respectively, for which we received net proceeds of \$215 and \$242, respectively. During the six months ended June 30, 2010 and 2009, 8,118 and 12,112 shares of Common stock were issued under our employee stock purchase plan, respectively, for which we received net proceeds of \$416 and \$425, respectively.

Noncontrolling Interest

We have a 60% controlling interest in Carrier Enterprise and Carrier has a 40% noncontrolling interest. The following table reconciles shareholders' equity attributable to the noncontrolling interest:

Fair value of noncontrolling interest at December 31, 2009	\$ 156,782
Net income attributable to noncontrolling interest	14,804
Distribution to noncontrolling interest	(3,115)
Noncontrolling interest at June 30, 2010	\$ 168,471

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We are involved in litigation incidental to the operation of our business. We vigorously defend all matters in which we or our subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments that may affect us. Although the adequacy of existing insurance coverage or the outcome of any legal proceedings cannot be predicted with certainty, based on the current information available, we do not believe the ultimate liability associated with any known claims or litigation in which we or our subsidiaries are involved will materially affect our financial condition or results of operations.

Self-Insurance

Self-insurance reserves are maintained relative to company-wide casualty insurance and health benefit programs. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverage. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occur and exceed these estimates, additional reserves may be required. The estimation process contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. Reserves in the amount of \$9,249 and \$7,110 at June 30, 2010 and December 31, 2009, respectively, were established related to such insurance programs and are included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

9. RELATED PARTY TRANSACTIONS

Purchases from Carrier and its affiliates comprised 54% of all purchases made for the quarter and six months ended June 30, 2010. At June 30, 2010, approximately \$157,000 is payable to Carrier and its affiliates. Carrier Enterprise also sells HVAC/R products to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statement of income for the quarter and six months ended June 30, 2010 include \$14,649 and \$18,048, respectively, of sales to Carrier and its affiliates. We believe these transactions are conducted at arm's-length in the ordinary course of business.

Carrier Enterprise has entered into Transactional Services Agreements (TSAs) with Carrier to have certain business processes performed on its behalf including processes involving the use of business software applications and information technologies. A number of the services provided pursuant to the TSAs expired on December 31, 2009, with the remaining services expiring at various dates throughout 2010. The fees related to the TSAs were approximately \$888 and \$2,227 and are included in selling, general and administrative expenses in our condensed consolidated unaudited statement of income for the quarter and six months ended June 30, 2010, respectively. At June 30, 2010 and December 31, 2009, \$1,722 and \$7,116, respectively, related to the TSAs is payable to Carrier and is included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

The final purchase price of Carrier Enterprise was subject to an adjustment pursuant to the Purchase and Contribution Agreement dated May 3, 2009, as amended June 29, 2009, of which \$1,418 was payable to Carrier at June 30, 2010 and December 31, 2009. Such amount is included in our condensed consolidated balance sheets.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
Safe Harbor Statement

This Quarterly Report contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions, (iv) financing plans and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based largely on management's current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including:

general economic conditions;

competitive factors within the HVAC/R industry;

effects of supplier concentration;

fluctuations in certain commodity costs;

consumer spending;

consumer debt levels;

new housing starts and completions;

capital spending in the commercial construction market;

access to liquidity needed for operations;

seasonal nature of product sales;

weather conditions;

insurance coverage risks;

federal, state and local regulations impacting our industry and products;

prevailing interest rates; and

the continued viability of our business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if substantially realized, that the information will have the expected consequences to or effects on our business or operations. For additional information identifying some other important factors which may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, see our Commission filings, including but not limited to, the discussion included in the Risk Factors section of our 2009 Annual Report on Form 10-K under the headings *Business Risk Factors* and *General Risk Factors*. Forward-looking statements speak only as of the date the statement was made. We assume no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information.

The following information should be read in conjunction with the condensed consolidated unaudited financial statements included under Item 1, *Condensed Consolidated Unaudited Financial Statements* of this Quarterly Report on Form 10-Q.

Company Overview

Watsco, Inc. and its subsidiaries (collectively, *Watsco*, which may be referred to as *we*, *us* or *our*) was incorporated in 1956 and is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies (*HVAC/R*) in the HVAC/R distribution industry. On July 1, 2009, we completed the formation of a joint venture with Carrier Corporation (*Carrier*), to distribute Carrier, Bryant and Payne products throughout the U.S. Sunbelt, Latin America and the Caribbean. In the formation of the joint venture, Carrier Enterprise, LLC (*Carrier Enterprise*), Carrier contributed 95 locations in the U.S. Sunbelt and Puerto Rico and the export division located in Miami, Florida and we contributed 15 locations that currently distribute Carrier, Bryant and Payne products. At June 30, 2010, we operated from 505 locations in 36 states.

Revenues primarily consist of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. Selling, general and administrative expenses primarily consist of selling expenses, the largest components of which are salaries, commissions and marketing expenses that tend to be variable in nature and correlate to changes in sales. Other significant selling, general and administrative expenses relate to the operation of warehouse facilities, including a fleet of trucks and forklifts and facility rent, which are payable mostly under non-cancelable operating leases.

Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on weather patterns during the summer and winter selling seasons. Demand related to the residential central air conditioning replacement market is highest in the second and third quarters, and demand for heating equipment is usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly consistent during the year except for dependence on housing completions and related weather and economic conditions.

Critical Accounting Policies

Management's discussion and analysis of financial condition and results of operations is based upon the condensed consolidated unaudited financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the condensed consolidated unaudited financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. At least quarterly, management reevaluates its judgments and estimates, which are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances.

Our critical accounting policies are included in our 2009 Annual Report on Form 10-K as filed on February 26, 2010. We believe that there have been no significant changes during the quarter and six months ended June 30, 2010 to the critical accounting policies disclosed in our 2009 Annual Report on Form 10-K.

Table of Contents**Recent Accounting Pronouncements**

Refer to Note 1 to the condensed consolidated unaudited financial statements for a discussion of recently issued accounting pronouncements.

Results of Operations

The following table summarizes information derived from the condensed consolidated unaudited statements of income expressed as a percentage of revenues for the quarters and six months ended June 30, 2010 and 2009:

	Quarter		Six Months	
	Ended June 30, 2010	2009	Ended June 30, 2010	2009
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of sales	76.7	75.1	76.5	74.8
Gross profit	23.3	24.9	23.5	25.2
Selling, general and administrative expenses	15.1	18.4	17.7	21.6
Operating income	8.2	6.5	5.8	3.6
Interest expense, net	0.1	0.1	0.1	0.1
Income before income taxes	8.1	6.4	5.7	3.5
Income taxes	2.5	2.4	1.8	1.3
Net income	5.6	4.0	3.9	2.2
Less: net income attributable to noncontrolling interest	1.5		1.1	
Net income attributable to Watsco, Inc.	4.1%	4.0%	2.8%	2.2%

The following narratives include the results of operations for businesses acquired during 2009 and 2010. The results of operations for these acquisitions have been included in the condensed consolidated unaudited statements of income beginning on their respective dates of acquisition. In the following narratives, computations and disclosure information referring to same-store basis exclude the effects of locations acquired or locations opened or closed during the prior twelve months unless they are within close geographical proximity to existing locations (95 locations excluded at June 30, 2010). The table below summarizes the changes in our locations during the quarter and six months ended June 30, 2010:

**Number of
Locations**