

WATSCO INC  
Form 10-Q  
November 05, 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 September 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)

**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  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  (Do not check if a smaller reporting company)

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: 28,073,990 shares of Common stock (\$0.50 par value), excluding treasury shares of 6,322,650, and 4,325,037 shares of Class B common stock (\$0.50 par value), excluding treasury shares of 48,263, were outstanding as of November 2, 2010.

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**WATSCO, INC. AND SUBSIDIARIES**

**QUARTERLY REPORT ON FORM 10-Q**

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

## WATSCO, INC. AND SUBSIDIARIES

## CONDENSED CONSOLIDATED UNAUDITED STATEMENTS OF INCOME

(In thousands, except per share data)

|  | Quarter Ended<br>September 30, |            | Nine Months Ended<br>September 30, |              |
|--|--------------------------------|------------|------------------------------------|--------------|
|  | 2010                           | 2009       | 2010                               | 2009         |
| Revenues   | \$ 812,787                     | \$ 741,895 | \$ 2,187,347                       | \$ 1,438,209 |
| Cost of sales  | 617,246                        | 569,886    | 1,668,133                          | 1,090,981    |
| Gross profit   | 195,541                        | 172,009    | 519,214                            | 347,228      |
| Selling, general and administrative expenses             | 131,548                        | 130,557    | 375,437                            | 281,044      |
| Operating income   | 63,993                         | 41,452     | 143,777                            | 66,184       |
| Interest expense, net                                    | 869                            | 1,031      | 2,660                              | 1,703        |
| Income before income taxes                               | 63,124                         | 40,421     | 141,117                            | 64,481       |
| Income taxes   | 19,606                         | 13,280     | 43,917                             | 22,230       |
| Net income   | 43,518                         | 27,141     | 97,200                             | 42,251       |
| Less: net income attributable to noncontrolling interest | 12,081                         | 6,010      | 26,885                             | 6,010        |
| Net income attributable to Watsco, Inc.                  | \$ 31,437                      | \$ 21,131  | \$ 70,315                          | \$ 36,241    |
| Earnings per share for Common and Class B common stock:  |                                |            |                                    |              |
| Basic  | \$ 0.97                        | \$ 0.66    | \$ 2.17                            | \$ 1.21      |
| Diluted  | \$ 0.97                        | \$ 0.66    | \$ 2.16                            | \$ 1.21      |

*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)

|   | September 30,<br>2010 | December 31,<br>2009 |
|---|-----------------------|----------------------|
|   | (Unaudited)           |                      |
| <b>ASSETS</b>                                       |                       |                      |
| Current assets:                                     |                       |                      |
| Cash and cash equivalents                           | \$ 99,871             | \$ 58,093            |
| Accounts receivable, net                            | 337,954               | 266,284              |
| Inventories   | 456,768               | 410,078              |
| Other current assets                                | 22,107                | 20,843               |
| <b>Total current assets</b>                         | <b>916,700</b>        | <b>755,298</b>       |
| Property and equipment, net                         | 30,999                | 33,118               |
| Goodwill  | 303,703               | 303,257              |
| Intangible assets, net                              | 57,089                | 58,566               |
| Other assets  | 8,433                 | 10,374               |
|   | <b>\$ 1,316,924</b>   | <b>\$ 1,160,613</b>  |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>         |                       |                      |
| Current liabilities:                                |                       |                      |
| Current portion of long-term obligations            | \$ 129                | \$ 151               |
| Accounts payable                                    | 235,623               | 145,825              |
| Accrued expenses and other current liabilities      | 93,108                | 77,950               |
| <b>Total current liabilities</b>                    | <b>328,860</b>        | <b>223,926</b>       |
| Long-term obligations:                              |                       |                      |
| Borrowings under revolving credit agreements        | 22,100                | 12,763               |
| Other long-term obligations, net of current portion | 564                   | 666                  |
| <b>Total long-term obligations</b>                  | <b>22,664</b>         | <b>13,429</b>        |
| Deferred income taxes and other liabilities         | 28,655                | 28,450               |
| Commitments and contingencies (Note 8)              |                       |                      |
| Watsco, Inc. shareholders' equity:                  |                       |                      |
| Common stock, \$0.50 par value                      | 17,190                | 17,105               |
| Class B common stock, \$0.50 par value              | 2,187                 | 2,150                |
| Preferred stock, \$0.50 par value                   |                       |                      |
| Paid-in capital                                     | 468,874               | 461,563              |
| Accumulated other comprehensive loss, net of tax    | (688)                 | (821)                |
| Retained earnings                                   | 393,584               | 372,454              |
| Treasury stock, at cost                             | (114,425)             | (114,425)            |

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|   |                     |              |
|---|---------------------|--------------|
| Total Watsco, Inc. shareholders' equity | <b>766,722</b>      | 738,026      |
| Noncontrolling interest                 | <b>170,023</b>      | 156,782      |
| Total shareholders' equity              | <b>936,745</b>      | 894,808      |
|   | <b>\$ 1,316,924</b> | \$ 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

Nine Months Ended September 30, 2010 and 2009

(In thousands)

|   | 2010             | 2009             |
|---|------------------|------------------|
| Cash flows from operating activities:   |                  |                  |
| Net income  | \$ 97,200        | \$ 42,251        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Depreciation and amortization   | 7,670            | 5,924            |
| Share-based compensation  | 3,799            | 3,791            |
| Excess tax benefits from share-based compensation                                 | (2,229)          | (9,038)          |
| Provision for doubtful accounts   | 1,931            | 3,558            |
| Gain on sale of property and equipment  | (421)            | (46)             |
| Other, net  | 3,566            | 2,654            |
| Changes in operating assets and liabilities, net of effects of acquisitions:      |                  |                  |
| Accounts receivable   | (73,031)         | 9,769            |
| Inventories   | (43,396)         | (44,291)         |
| Accounts payable and other liabilities  | 100,796          | 22,328           |
| Other, net  | 810              | 1,583            |
| <b>Net cash provided by operating activities</b>                                  | <b>96,695</b>    | <b>38,483</b>    |
| Cash flows from investing activities:   |                  |                  |
| Capital expenditures  | (5,540)          | (4,187)          |
| Business acquisitions, net of cash acquired                                       | (3,824)          | (4,057)          |
| Proceeds from sale of property and equipment                                      | 2,080            | 188              |
| <b>Net cash used in investing activities</b>                                      | <b>(7,284)</b>   | <b>(8,056)</b>   |
| Cash flows from financing activities:   |                  |                  |
| Dividends on Common and Class B common stock                                      | (49,185)         | (41,706)         |
| Distributions to noncontrolling interest  | (13,644)         |                  |
| Net repayments of other long-term obligations                                     | (124)            | (184)            |
| Payment of fees related to revolving credit agreements                            |                  | (6,695)          |
| Excess tax benefits from share-based compensation                                 | 2,229            | 9,038            |
| Net proceeds from issuances of common stock                                       | 3,754            | 9,993            |
| Net proceeds under revolving credit agreements                                    | 9,337            | 23,000           |
| <b>Net cash used in financing activities</b>                                      | <b>(47,633)</b>  | <b>(6,554)</b>   |
| <b>Net increase in cash and cash equivalents</b>                                  | <b>41,778</b>    | <b>23,873</b>    |
| <b>Cash and cash equivalents at beginning of period</b>                           | <b>58,093</b>    | <b>41,444</b>    |
| <b>Cash and cash equivalents at end of period</b>                                 | <b>\$ 99,871</b> | <b>\$ 65,317</b> |

## Supplemental cash flow information (Note 10)

See accompanying notes to condensed consolidated unaudited financial statements.





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WATSCO, INC. AND SUBSIDIARIES

NOTES TO CONDENSED CONSOLIDATED UNAUDITED FINANCIAL STATEMENTS

September 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 September 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 include the accounts of a joint venture in which Watsco maintains a 60% controlling interest. All significant intercompany balances and transactions have been eliminated.

The results of operations for the quarter and nine months ended September 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 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 for 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*

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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 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.

### **Recently Issued Accounting Standards**

#### *Amendments to Revenue Arrangements with Multiple Deliverables*

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 consolidated financial statements.

**Table of Contents****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 for our Common stock assumes the conversion of all of our Class B common stock 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. As of September 30, 2010 and 2009, our outstanding Class B common stock was convertible into 2,858,592 and 2,833,916 shares of our Common stock, respectively.

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 nine months ended September 30, 2010 and 2009:

|  | Quarter Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|--|--------------------------------|------------|------------------------------------|------------|
|  | 2010                           | 2009       | 2010                               | 2009       |
| <b>Basic Earnings per Share:</b>   |                                |            |                                    |            |
| Net income attributable to Watsco, Inc. shareholders   | \$ 31,437                      | \$ 21,131  | \$ 70,315                          | \$ 36,241  |
| Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock | 1,835                          | 1,162      | 4,182                              | 2,480      |
| Earnings allocated to Watsco, Inc. shareholders  | \$ 29,602                      | \$ 19,969  | \$ 66,133                          | \$ 33,761  |
| Allocation of earnings for Basic:  |                                |            |                                    |            |
| Common stock   | \$ 26,828                      | \$ 18,094  | \$ 59,923                          | \$ 30,335  |
| Class B common stock   | 2,774                          | 1,875      | 6,210                              | 3,426      |
|  | \$ 29,602                      | \$ 19,969  | \$ 66,133                          | \$ 33,761  |
| <b>Diluted Earnings per Share:</b>   |                                |            |                                    |            |
| Net income attributable to Watsco, Inc. shareholders   | \$ 31,437                      | \$ 21,131  | \$ 70,315                          | \$ 36,241  |
| Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock | 1,833                          | 1,159      | 4,178                              | 2,480      |
| Earnings allocated to Watsco, Inc. shareholders  | \$ 29,604                      | \$ 19,972  | \$ 66,137                          | \$ 33,761  |
| Weighted-average Common and Class B common shares outstanding for basic earnings per share     |                                |            |                                    |            |
|  | 30,499,889                     | 30,178,749 | 30,442,941                         | 27,922,382 |
| Effect of dilutive stock options   | 101,332                        | 258,325    | 115,792                            |            |
| Weighted-average Common and Class B common shares outstanding for diluted earnings per share   |                                |            |                                    |            |
|  | 30,601,221                     | 30,437,074 | 30,558,733                         | 27,922,382 |

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.

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Diluted earnings per share excluded 199,826 and 152,940 shares for the quarters ended September 30, 2010 and 2009, respectively, and 144,756 and 243,055 shares for the nine months ended September 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.

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**Table of Contents****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 in 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 condensed consolidated statements of income when the hedged item affects earnings. Our interest rate hedge described below is designated as a cash flow hedge.

At both September 30, 2010 and December 31, 2009, we had one interest rate swap agreement 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%. For the quarters and nine months ended September 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%. For the quarter and nine months ended September 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 \$519 and \$710 at September 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 September 30, 2010 and December 31, 2009, \$312, net of deferred tax benefits of \$191 and \$432, net of deferred tax benefits of \$262, respectively, was included in accumulated other comprehensive loss ( OCL ) associated with cash flow hedge.

The net change in OCL for the quarters and nine months ended September 30, 2010 and 2009, reflected the reclassification of \$76, net of income tax benefit of \$46, \$152, net of income tax benefit of \$92, \$225, net of income tax benefit of \$138 and \$441, net of income tax benefit of \$268, 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 \$500 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 (0.33% at September 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.
- 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.

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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 tables present 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<br>at<br>September 30,<br>2010 | Fair Value Measurements<br>at September 30, 2010 Using |         |         |
|---------------------------------|---|--|---------|---------|
|                                 |   | Level 1  | Level 2 | Level 3 |
| <b>Assets:</b>                  |   |  |         |         |
| Available-for-sale securities   | \$ 124                                    | \$ 124   |         |         |
| <b>Liabilities:</b>             |   |  |         |         |
| Derivative financial instrument | \$ 519                                    |  | \$ 519  |         |

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| Description                     | Fair Value<br>at<br>December 31,<br>2009 | Fair Value Measurements<br>at December 31, 2009 Using |         |         |
|---------------------------------|--|---|---------|---------|
|                                 |  | Level 1   | Level 2 | Level 3 |
| <b>Assets:</b>                  |  |   |         |         |
| Available-for-sale securities   | \$ 104                                   | \$ 104  |         |         |
| <b>Liabilities:</b>             |  |   |         |         |
| 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. The fair value of available-for-sale securities is included in other assets in our condensed consolidated balance sheets.

*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. The fair value of the derivative financial instrument is included, net of accrued interest, in deferred income taxes and other liabilities in our condensed consolidated balance sheets. See Note 3, Derivative Financial Instruments.

**5. COMPREHENSIVE INCOME**

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 discussed in Note 3, Derivative Financial Instruments. The components of comprehensive income for the quarters and nine months ended September 30, 2010 and 2009, respectively, are as follows:

|  | Quarter Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|--------------------------------|-----------|------------------------------------|-----------|
|  | 2010                           | 2009      | 2010                               | 2009      |
| Net income   | \$ 43,518                      | \$ 27,141 | \$ 97,200                          | \$ 42,251 |
| Changes in unrealized losses on derivative instruments, net of income tax expense of \$(31), \$(51), \$(71) and \$(166), respectively              | 52                             | 79        | 120                                | 283       |
| Changes in unrealized losses on available-for-sale securities, net of income tax (expense) benefit of \$(12), \$(10), \$(7) and \$21, respectively | 17                             | 14        | 13                                 | (30)      |
| Comprehensive income   | 43,587                         | 27,234    | 97,333                             | 42,504    |
| Less: comprehensive income attributable to noncontrolling interest   | 12,081                         | 6,010     | 26,885                             | 6,010     |
| Comprehensive income attributable to Watsco, Inc.  | \$ 31,506                      | \$ 21,224 | \$ 70,448                          | \$ 36,494 |

**6. ACQUISITIONS**

In April 2010, one of our wholly-owned subsidiaries acquired certain assets and assumed certain liabilities of a wholesale distributor of air conditioning and heating products operating from two locations in Tennessee for cash consideration of approximately \$2,400.

In August 2009, one of our wholly-owned subsidiaries acquired certain assets and assumed certain liabilities of a wholesale distributor of air conditioning and heating products operating from six locations in Utah and serving over 500 customers for cash consideration of \$4,057, net of cash acquired.

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In July 2009, we completed the formation of Carrier Enterprise, LLC ( Carrier Enterprise ), which is a joint venture between us and Carrier Corporation ( Carrier ). Carrier contributed to Carrier Enterprise 95 locations in the U.S. Sunbelt and Puerto Rico and Carrier's export division located in Miami, Florida, and we contributed 15 locations that distributed Carrier products. We purchased a 60% controlling interest in the joint venture for a fair value of \$181,474 with options to purchase up to an additional 20% interest from Carrier (10% beginning in July 2012 and an additional 10% in July 2014). Total consideration paid by us for our 60% controlling interest in Carrier Enterprise was composed of our issuance to Carrier of 2,985,685 shares of Common stock and 94,784 shares of Class B common stock having a fair value of \$151,056 and our contribution of 15 locations that sold Carrier-manufactured products valued at \$25,000. The final purchase price was subject to \$5,418 of working capital adjustments pursuant to the Purchase and Contribution Agreement dated May 3, 2009, as amended June 29, 2009, ( Purchase and Contribution Agreement ) and was completed during the fourth quarter of 2009.



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The results of operations of these acquired locations have been included in our condensed consolidated unaudited financial statements from their respective dates of acquisition. The pro forma effect of the April 2010 and August 2009 acquisitions were not deemed significant to the condensed consolidated unaudited financial statements.

Acquisition-related costs of \$2,503 and \$3,833 were included in selling, general and administrative expenses in our condensed consolidated unaudited statements of income for the quarter and nine months ended September 30, 2009, respectively.

## **7. SHAREHOLDERS EQUITY**

### **Common Stock Issued**

On July 1, 2009, as a result of the formation of Carrier Enterprise, we issued 2,985,685 shares of Common stock and 94,784 shares of Class B common stock having a fair value of \$151,056 to Carrier. See Note 6, Acquisitions.

### **Dividends Declared**

Our Board of Directors declared cash dividends on both Common and Class B common stock of \$0.52 per share, \$0.48 per share, \$1.52 per share and \$1.41 per share for the quarters and nine months ended September 30, 2010 and 2009, respectively. On October 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 October 29, 2010 to shareholders of record as of October 15, 2010.

### **Non-Vested (Restricted) Stock**

No shares of non-vested (restricted) stock were granted during the quarter ended September 30, 2010. During the quarter ended September 30, 2009, we granted 10,000 shares of non-vested (restricted) stock. During the nine months ended September 30, 2010 and 2009, we granted 135,000 and 10,000 shares of non-vested (restricted) stock, respectively. During the quarter ended September 30, 2010, 14,567 shares of Common stock with an aggregate market value of \$862 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 nine months ended September 30, 2010 and 2009, 19,678 shares of Common stock with an aggregate market value of \$1,155 and 601 shares of Common stock with an aggregate market value of \$23, 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 September 30, 2010 and 2009, 7,250 and 344,550, respectively, of stock options were exercised for Common and Class B common stock. During the nine months ended September 30, 2010 and 2009, 182,100 and 764,600, 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 nine months ended September 30, 2010 and 2009, was \$355, \$3,982, \$3,163 and \$9,404, respectively. During the quarter ended September 30, 2009, 94,651 shares of Common and Class B common stock with an aggregate market value of \$5,110 were delivered as payment in lieu of cash for stock option exercises and related tax withholdings. These shares were retired upon delivery. During the nine months ended September 30, 2010 and 2009, 48,938 shares of Class B common stock with an aggregate market value of \$2,814 and 186,593 shares of Common and Class B common stock with an aggregate market value of \$8,444, 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 September 30, 2010 and 2009, 3,192 and 3,292 shares of Common stock were issued under our employee stock purchase plan, respectively, for which we received net proceeds of \$175 and \$164, respectively. During the nine months ended September 30, 2010 and 2009, 11,310 and 15,404 shares of Common stock were issued under our employee stock purchase plan, respectively, for which we received net proceeds of \$591 and \$589, respectively.

### **Noncontrolling Interest**

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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         | 26,885            |
| Distributions to noncontrolling interest                   | (13,644)          |
| Noncontrolling interest at September 30, 2010              | <b>\$ 170,023</b> |

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**Table of Contents****8. COMMITMENTS AND CONTINGENCIES****Litigation, Claims and Assessments**

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 amounts of \$7,109 and \$7,110 at September 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 48% and 57% of all purchases made for the quarters ended September 30, 2010 and 2009, respectively. For the nine months ended September 30, 2010 and 2009, purchases from Carrier and its affiliates comprised 52% and 36% of all purchases made, respectively. At September 30, 2010 and December 31, 2009, approximately \$110,000 and \$61,000, respectively, was payable to Carrier and its affiliates. Carrier Enterprise also sells HVAC/R products to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statements of income for the quarter and nine months ended September 30, 2010 include \$6,025 and \$16,332, respectively, of sales to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statements of income for both the quarter and nine months ended September 30, 2009 include \$6,603 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 had 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 on various dates throughout 2010. The fees related to the TSAs were \$2,227 and \$3,000, and are included in selling, general and administrative expenses in our condensed consolidated unaudited statements of income for the nine months ended September 30, 2010 and 2009, respectively. At September 30, 2010 and December 31, 2009, \$1,722 and \$7,116, respectively, related to the TSAs was payable to Carrier and is included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

The final purchase price for Carrier Enterprise was subject to an adjustment pursuant to the Purchase and Contribution Agreement, of which \$1,418 was paid to Carrier during the quarter ended September 30, 2010.

**10. SUPPLEMENTAL CASH FLOW INFORMATION**

Non-cash investing and financing activities were as follows:

*Nine Months Ended September 30,*

**2010**

**2009**

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|   |            |
|---|------------|
| Common and Class B common stock issued for joint venture              | \$ 151,056 |
| Locations contributed to joint venture                                | \$ 25,000  |
| Non-cash capital contribution of inventory by noncontrolling interest | \$ 32,000  |

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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;

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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 and notes thereto included under Item 1 of this Quarterly Report on Form 10-Q. In addition, reference should be made to our audited consolidated financial statements and notes thereto and related Management's Discussion and Analysis of Financial Condition and Results of Operations included in our 2009 Annual Report on Form 10-K.

### 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. At September 30, 2010, we operated from 507 locations in 36 states and Puerto Rico with additional market coverage on an export basis to parts of Latin America and the Caribbean.

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 are variable 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.

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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 nine months ended September 30, 2010 to the critical accounting policies disclosed in our 2009 Annual Report on Form 10-K.

**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 nine months ended September 30, 2010 and 2009:

|  | Quarter<br>Ended September 30, |        | Nine Months<br>Ended September 30, |        |
|--|--------------------------------|--------|------------------------------------|--------|
|  | 2010                           | 2009   | 2010                               | 2009   |
| Revenues   | 100.0%                         | 100.0% | 100.0%                             | 100.0% |
| Cost of sales  | 75.9                           | 76.8   | 76.3                               | 75.9   |
| Gross profit   | 24.1                           | 23.2   | 23.7                               | 24.1   |
| Selling, general and administrative expenses             | 16.2                           | 17.6   | 17.1                               | 19.5   |
| Operating income   | 7.9                            | 5.6    | 6.6                                | 4.6    |
| Interest expense, net                                    | 0.1                            | 0.1    | 0.1                                | 0.1    |
| Income before income taxes                               | 7.8                            | 5.5    | 6.5                                | 4.5    |
| Income taxes   | 2.4                            | 1.8    | 2.1                                | 1.6    |
| Net income   | 5.4                            | 3.7    | 4.4                                | 2.9    |
| Less: net income attributable to noncontrolling interest | 1.5                            | 0.8    | 1.2                                | 0.4    |
| Net income attributable to Watsco, Inc.                  | 3.9%                           | 2.9%   | 3.2%                               | 2.5%   |

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 (19 locations were excluded at September 30, 2010). The table below summarizes the changes in our locations for the quarter and nine months ended September 30, 2010:

|                   | Number of<br>Locations |
|-------------------|------------------------|
| December 31, 2009 | 505                    |
| Closed            | (1)                    |
| March 31, 2010    | 504                    |
| Acquired          | 2                      |
| Opened            | 3                      |
| Closed            | (4)                    |

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|                    |     |
|--------------------|-----|
| June 30, 2010      | 505 |
| Opened             | 2   |
| September 30, 2010 | 507 |



**Table of Contents****Third Quarter 2010 Compared to Third Quarter 2009***Revenues*

Revenues for the quarter ended September 30, 2010 increased \$70.9 million, or 10%, compared to the same period in 2009, including a \$6.5 million contribution from locations acquired and opened during the last twelve months partially offset by \$5.6 million from closed locations. Revenues reflect an 8% increase in sales of HVAC equipment, an 11% increase in sales of other HVAC products and a 19% increase in sales of refrigeration products. On a same-store basis, revenues increased \$70.0 million, or 10%, as compared to the same period in 2009. The increase in same-store revenues is primarily due to price increases and sales growth of higher-efficiency replacement air conditioning and heating systems, which sell at higher unit prices, and strong demand for the replacement of residential and light-commercial HVAC products.

*Gross Profit*

Gross profit for the quarter ended September 30, 2010 increased \$23.5 million, or 14%, compared to the same period in 2009, primarily as a result of increased revenues. Gross profit margin for the quarter ended September 30, 2010 improved 90 basis-points to 24.1% versus 23.2% for the same period in 2009, primarily due to a shift in sales mix toward non-equipment products, which generates a higher gross profit margin than HVAC equipment, as well as higher margins on higher-efficiency air conditioning and heating systems.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses for the quarter ended September 30, 2010 increased \$1.0 million, or 1%, compared to the same period in 2009. Selling, general and administrative expenses as a percent of revenues for the quarter ended September 30, 2010 decreased to 16.2% from 17.6% for the same period in 2009. On a same-store basis and excluding acquisition-related costs of \$2.5 million, selling, general, and administrative expenses increased 3% primarily due to an increase in selling expenses from higher revenues. Closed branches also contributed selling, general and administrative expenses savings of \$1.0 million during the quarter ended September 30, 2010.

*Interest Expense, Net*

Net interest expense for the quarter ended September 30, 2010 decreased \$.2 million, or 16%, compared to the same period in 2009, primarily as a result of a 31% decrease in average outstanding borrowings as compared to the same period in 2009.

*Income Taxes*

Income taxes of \$19.6 million for the quarter ended September 30, 2010 consist of the income taxes attributable to Watsco's wholly-owned operations and 60% of income taxes attributable to Carrier Enterprise, LLC (Carrier Enterprise), which is taxed as a partnership for income tax purposes. The effective income tax rate attributable to Watsco decreased to 38.0% from 38.2% for the quarters ended September 30, 2010 and 2009. The decrease is primarily due to certain non-recurring tax benefits and credits realized in the third quarter of 2010 as compared to the third quarter of 2009.

*Net Income Attributable to Watsco*

Net income attributable to Watsco for the quarter ended September 30, 2010 increased \$10.3 million, or 49%, compared to the same period in 2009. The increase was primarily driven by higher revenues, expanded profit margins and lower levels of selling, general and administrative expenses as a percent of revenues as discussed above.

**Nine Months Ended September 30, 2010 Compared to Nine Months Ended September 30, 2009***Revenues*

Revenues for the nine months ended September 30, 2010 increased \$749.1 million, or 52%, compared to the same period in 2009, including a \$625.4 million attributable to the new Carrier Enterprise locations and \$19.6 million from other locations acquired and opened during the last twelve months partially offset by \$11.8 million from closed locations. On a same-store basis, revenues increased \$115.9 million, or 8%, over the same period in 2009. Revenues reflect a 14% increase in sales of HVAC equipment, a 1% increase in sales of other HVAC products and an 8%

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increase in sales of refrigeration products. Sales of HVAC equipment benefited from growth in unit sales and an improved sales mix of higher-efficiency replacement air conditioning and heating systems, which sell at higher unit prices.

*Gross Profit*

Gross profit for the nine months ended September 30, 2010 increased \$172.0 million, or 50%, compared to the same period in 2009, primarily as a result of increased revenues. Gross profit margin for the nine months ended September 30, 2010 declined 40 basis-points to 23.7% versus 24.1% for the same period in 2009, reflecting the impact of lower selling margins for Carrier Enterprise. On a same-store basis, gross profit margin improved 50 basis-points to 24.7% versus 24.2% primarily due to a shift in sales mix toward higher-efficiency HVAC equipment as well as improved margins for non-equipment products.

*Selling, General and Administrative Expenses*

Selling, general and administrative expenses for the nine months ended September 30, 2010 increased \$94.4 million, or 34%, compared to the same period in 2009 primarily due to Carrier Enterprise. Selling, general and administrative expenses as a percent of revenues for the nine months ended September 30, 2010 decreased to 17.1% from 19.5% for the same period in 2009. On a same-store basis and excluding acquisition-related costs of \$3.8 million, selling, general, and administrative expenses were flat. Closed branches also contributed selling, general and administrative expenses savings of \$2.5 million during the nine months ended September 30, 2010.

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### *Interest Expense, Net*

Net interest expense for the nine months ended September 30, 2010 increased \$1.0 million, or 56%, compared to the same period in 2009, primarily as a result of the additional amortization of bank fees (included in interest expense, net) related to the amendment of our existing revolving credit agreement required to consummate the joint venture and the establishment of the Carrier Enterprise revolving credit agreement.

### *Income Taxes*

Income taxes of \$43.9 million for the nine months ended September 30, 2010 consist of the income taxes attributable to Watsco's wholly-owned operations and 60% of income taxes attributable to Carrier Enterprise, which is taxed as a partnership for income tax purposes. The effective income tax rate attributable to Watsco increased to 38.0% from 37.8% for the nine months ended September 30, 2010 and 2009. The increase is primarily due to certain non-recurring tax benefits and credits realized in 2009 and a higher state effective tax rate associated with Carrier Enterprise in 2010.

### *Net Income Attributable to Watsco*

Net income attributable to Watsco for the nine months ended September 30, 2010 increased \$34.1 million, or 94%, compared to the same period in 2009. The increase was primarily driven by higher revenues, expanded profit margins and lower levels of selling, general and administrative expenses as a percent of revenues as discussed above.

## **Liquidity and Capital Resources**

We assess our liquidity in terms of our ability to generate cash to execute our business strategy and fund operating and investing activities, taking into consideration the seasonal demand of HVAC/R products, which peaks in the months of May through August. Significant factors that could affect our liquidity include the following:

cash flows generated from operating activities;

the adequacy of available bank lines of credit;

the ability to attract long-term capital with satisfactory terms;

acquisitions;

dividend payments;

capital expenditures; and

the timing and extent of common stock repurchases.

We rely on cash flows from operations and our lines of credit to fund seasonal working capital needs, financial commitments and short-term liquidity needs, including funds necessary for business acquisitions. We believe that, at present, cash flows from operations combined with those available under our lines of credit are sufficient to satisfy our current liquidity needs, including our anticipated dividend payments and capital expenditures. Any future disruption in the capital and credit markets, such as those experienced in 2008, could adversely affect our ability to

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draw on our lines of credit. Our access to funds under the lines of credit is dependent on the ability of the banks to meet their funding commitments. Disruptions in capital and credit markets also may affect the determination of interest rates for borrowers, particularly rates based on LIBOR, as are our lines of credit. Any future disruptions in these markets and their effect on interest rates could result in increased borrowing costs under our lines of credit.

### *Cash Flows*

The following table summarizes our cash flow activity for the nine months ended September 30, 2010 and 2009:

|                      | 2010      | 2009     | Change    |
|----------------------|-----------|----------|-----------|
| Operating activities | \$ 96.7   | \$ 38.5  | \$ 58.2   |
| Investing activities | \$ (7.3)  | \$ (8.1) | \$ 0.8    |
| Financing activities | \$ (47.6) | \$ (6.6) | \$ (41.0) |

A detail of the individual items contributing to the cash flow changes for the periods presented is included in the condensed consolidated unaudited statements of cash flows.

### Operating Activities

The increase in net cash provided by operating activities was principally attributable to higher net income and to changes in operating assets and liabilities, which were primarily composed of higher levels of accounts payable and other liabilities, partially offset by higher accounts receivable driven by increased sales volume in 2010 versus 2009.

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### **Investing Activities**

The decrease in net cash used in investing activities is primarily due to an increase in capital expenditures of \$1.4 million partially offset by \$1.9 million of higher proceeds from the sale of property and equipment in 2010 as compared to the 2009 period.

### **Financing Activities**

The increase in net cash used in financing activities is primarily the result of a \$13.6 million distribution made to the noncontrolling interest in Carrier Enterprise, \$13.7 million lower net borrowings under our revolving credit agreements in 2010, an increase of \$7.5 million in dividends paid, a \$6.8 million decrease in excess tax benefits resulting from share-based compensation in 2010 and \$6.2 million lower net proceeds from issuances of common stock partially offset by \$6.7 million revolving credit agreement fees paid in 2009.

Working capital increased \$56.4 million to \$587.8 million at September 30, 2010 from \$531.4 million at December 31, 2009, reflecting higher cash on hand resulting from improved collections as well as due to an increase in inventory levels and accounts receivable; partially offset by higher levels of accounts payable and accrued expenses.

### ***Revolving Credit Agreements***

We maintain a bank-syndicated, unsecured revolving credit agreement that provides for borrowings of up to \$300.0 million. Borrowings are used to fund seasonal working capital needs and for other general corporate purposes, including acquisitions, dividends, stock repurchases and issuances of letters of credit. The credit facility matures in August 2012. At September 30, 2010 and December 31, 2009, \$22.1 million and \$12.8 million were outstanding under this revolving credit agreement, respectively.

The revolving credit agreement contains customary affirmative and negative covenants including financial covenants with respect to consolidated leverage and interest coverage ratios and limits capital expenditures, dividends and share repurchases in addition to other restrictions. We believe we were in compliance with all covenants and financial ratios at September 30, 2010.

Carrier Enterprise maintains a separate secured revolving credit agreement that provides for borrowings of up to \$75.0 million. Borrowings under the credit facility are used by Carrier Enterprise for general corporate purposes, including working capital and permitted acquisitions. The credit facility is secured by substantially all tangible and intangible assets of Carrier Enterprise. The credit facility matures in July 2012. At December 31, 2009, \$0.01 million was outstanding under this credit facility. At September 30, 2010, no borrowings were outstanding under this credit facility.

The revolving credit agreement contains customary affirmative and negative covenants and warranties, including compliance with a monthly borrowing base certificate with advance rates on accounts receivable and inventory, two financial covenants with respect to Carrier Enterprise's leverage and interest coverage ratios and limits the level of capital expenditures in addition to other restrictions. We believe Carrier Enterprise was in compliance with all covenants and financial ratios at September 30, 2010.

### ***Company Share Repurchase Program***

In September 1999, our Board of Directors authorized the repurchase, at management's discretion, of 7.5 million shares of common stock in the open market or via private transactions. Shares repurchased under the program are accounted for using the cost method and result in a reduction of shareholders' equity. In aggregate, 6.4 million shares of Common stock and Class B common stock have been repurchased at a cost of \$114.4 million since the inception of the program. The remaining 1.1 million shares authorized for repurchase are subject to certain restrictions included in our revolving credit agreement.

### ***Common Stock Dividends***

Cash dividends of \$1.52 per share and \$1.41 per share of Common stock and Class B common stock were paid for the nine months ended September 30, 2010 and 2009, respectively. On October 1, 2010, our Board of Directors declared a regular quarterly cash dividend of \$0.52 per share of Common stock and Class B common stock that was paid on October 29, 2010 to shareholders of record as of October 15, 2010. Future dividends and/or dividend rate increases will be at the sole discretion of the Board of Directors and will depend upon such factors as profitability, financial condition, cash requirements, restrictions under our revolving credit agreement, future prospects and other factors deemed

relevant by our Board of Directors.

*Capital Resources*

We believe we have adequate availability of capital from operations and our current credit facilities to fund working capital requirements and support the development of our short-term and long-term operating strategies. As of September 30, 2010, we had \$99.9 million of cash and cash equivalents available on hand, of which \$6.0 million is available for debt repayment. Additional borrowing capacity (subject to certain restrictions) under our revolving credit agreements is available to fund present operations and anticipated growth, including expansion in our current and targeted market areas. Potential acquisitions are continually evaluated and discussions are conducted with a number of acquisition candidates. Should suitable acquisition opportunities or working capital needs arise that would require additional financing, we believe our financial position and earnings history provide a sufficient base for obtaining additional financing resources at competitive rates and terms or gives us the ability to raise funds through the issuance of equity securities.

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**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures about Market Risk, of the 2009 Annual Report on Form 10-K.

**ITEM 4. CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended ( the Exchange Act )) that are, among other things, designed to ensure that information required to be disclosed by us under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer ( CEO ), Senior Vice President ( SVP ) and Chief Financial Officer ( CFO ), to allow for timely decisions regarding required disclosure and appropriate Securities and Exchange Commission filings.

Our management, with the participation of our CEO, SVP and CFO, has evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, and, based on that evaluation, our CEO, SVP and CFO have concluded that our disclosure controls and procedures were effective, at a reasonable assurance level, at and as of such date.

**Changes in Internal Control over Financial Reporting**

We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout the Company. However, there have been no changes in internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2010, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. In accordance with the rules and regulations of the Securities and Exchange Commission, we have not yet assessed the internal control over financial reporting of the 95 locations added by Carrier Enterprise on July 1, 2009, which represents approximately 45% of our total consolidated assets at September 30, 2010 and approximately 46% of revenues for the nine months ended September 30, 2010. From the acquisition date to September 30, 2010, the processes and systems of Carrier Enterprise were discrete and did not impact internal controls over financial reporting for our other consolidated subsidiaries.

**PART II. OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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 will have a material impact to our financial condition or results of operations.

**ITEM 1A. RISK FACTORS**

Information about risk factors for the quarter ended September 30, 2010, does not differ materially from that set forth in Part I, Item 1A, of our 2009 Annual Report on Form 10-K.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None



**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. REMOVED AND RESERVED**

**ITEM 5. OTHER INFORMATION**

None

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**ITEM 6. EXHIBITS**

|           |  |
|-----------|--|
| 31.1 #    | Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                      |
| 31.2 #    | Certification of Senior Vice President pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                         |
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| 32.1 +    | Certification of Chief Executive Officer, Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002. |
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| 101.SCH * | XBRL Taxonomy Extension Schema Document.   |
| 101.CAL * | XBRL Taxonomy Extension Calculation Linkbase Document.   |
| 101.DEF * | XBRL Taxonomy Extension Definition Linkbase Document.  |
| 101.LAB * | XBRL Taxonomy Extension Label Linkbase Document.   |
| 101.PRE * | XBRL Taxonomy Extension Presentation Linkbase Document.  |

# filed herewith.

+ furnished herewith.

\* XBRL (Extensible Business Reporting Language) information is furnished and not filed or a part of a registration statement or prospectus for purposes of sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

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**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

WATSCO, INC.  
(Registrant)

By: /s/ Ana M. Menendez  
Ana M. Menendez  
Chief Financial Officer  
(on behalf of the Registrant and as Principal  
Financial Officer)

November 5, 2010

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**INDEX TO EXHIBITS**

| <b>Exhibit No.</b> | <b>Exhibit Description</b>   |
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