Watsco, Inc. (WSO)

Baird Facts

Please refer to Appendix - Important Disclosures and Analyst Certification.

<table>
<thead>
<tr>
<th>Price ($) (5/28/20):</th>
<th>176.67</th>
</tr>
</thead>
<tbody>
<tr>
<td>52WK H-L ($) :</td>
<td>187 - 133</td>
</tr>
<tr>
<td>Market Cap (mil):</td>
<td>6,766</td>
</tr>
<tr>
<td>Shares Out (mil):</td>
<td>38.3</td>
</tr>
<tr>
<td>Float (mil):</td>
<td>32.5</td>
</tr>
<tr>
<td>Avg. Daily Vol (mil):</td>
<td>0.34</td>
</tr>
<tr>
<td>Dividend ($) :</td>
<td>7.10</td>
</tr>
<tr>
<td>Yield (%):</td>
<td>4.0</td>
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<tr>
<td>Rating:</td>
<td>Neutral</td>
</tr>
<tr>
<td>Price Target ($) :</td>
<td>168</td>
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<tr>
<td>L-Term Rev. Gr Rate Est:</td>
<td>8%</td>
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<tr>
<td>L-Term EPS Gr Rate Est:</td>
<td>18%</td>
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<tr>
<td>Debt/Cap:</td>
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<tr>
<td>ROE:</td>
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<tr>
<td>EBITDA ROIC:</td>
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<tr>
<td>Neutral Average Risk</td>
<td>FY Dec</td>
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<tr>
<td>Q1</td>
<td>0.88A</td>
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<tr>
<td>Q2</td>
<td>2.40A</td>
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<td>Q3</td>
<td>2.20A</td>
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<tr>
<td>Q4</td>
<td>0.92A</td>
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<tr>
<td>Total</td>
<td>6.52A</td>
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<tr>
<td>2019A 2020E 2021E</td>
<td></td>
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<table>
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<tr>
<th>Headquartered</th>
<th>IPO/Founded</th>
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<tbody>
<tr>
<td>Coconut Grove, FL</td>
<td>1985 / 1945</td>
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<table>
<thead>
<tr>
<th>Management</th>
<th>Dec 2019A 2020E 2021E</th>
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<tbody>
<tr>
<td>Al Nahmad Chair &amp; CEO</td>
<td>Revenue (Mil) 4,770.4 4,774.7 4,775.8</td>
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<tr>
<td>Aaron (A.J.) Nahmad</td>
<td>% Growth 4.9% 0.1% 0.0%</td>
</tr>
<tr>
<td>Barry Logan EVP &amp; Secy</td>
<td>Operating Margin 7.7% 6.7% 6.9%</td>
</tr>
<tr>
<td>Paul Johnston SVP, O/C</td>
<td>EBITDA Margin 8.2% 7.2% 7.4%</td>
</tr>
<tr>
<td>Ana Menendez CFO &amp; Tresurer</td>
<td>Contribution Margin NM NM NM</td>
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</table>

Company Description

Watsco is the leading independent US distributor of heating, ventilating, air conditioning and refrigeration (HVAC/R) equipment and related products, with approximately 560 locations and 2019 sales of $4.8 billion. Watsco primarily distributes residential central air conditioning products to over 90,000 US HVAC contractors, who, in turn, sell the systems to homeowners. Watsco’s focus on the replacement market in the US Sunbelt, where air conditioning is a necessity rather than a luxury, allows for a more stable, predictable demand curve (presently it is estimated that 85% of HVAC sales are replacement in nature). The company has leading market positions in the key air conditioning states of Florida, Texas, California, Georgia and the Carolinas.

Revenue Profile

- Recurring revenue: Approximately 85% of sales are related to repair or replacement.
- Customer concentration: No customer represents a significant portion of revenue.
- Supplier concentration: Top 10 suppliers represent 83% of purchases, including 62% from Carrier (UTX).

Sales by Geography

- 87% US
- 7% Latin America
- 6% Canada
- 6% Commercial Refrigeration

Sales by Product Line

- 67% Equipment
- 28% Parts
- 5% Commercial Refrigeration

Source: Company data, Baird estimates

Competition

- WSO has approximately 13% share of the $35+ billion North America HVAC distribution channel.
- Competitors include regional HVAC distributors and captive distributors (OEMs).
Investment Thesis

Quick summary:

- **The call.** We rate WSO Neutral. While we see the company’s recently increased dividend limiting downside to the shares, the payout ratio is becoming further stretched, potentially limiting future dividend increases given the company’s debt aversion. We also see several margin headwinds dampening operating leverage in 2020, which coupled with cyclical headwinds, creates a challenging setup for outperformance.

- **Price target and valuation.** Our $168 price target is based on ~30x PE on 2021E EPS, above the average NTM ranges of 21-26x seen over the past five years due to depressed near-term earnings power, but also based on a forward dividend yield of ~4%.

Near-term thesis:

- **Likely cyclical shift to repair (vs. replace) looming.** As consumers come under pressure, we believe WSO will see an increased incidence of repair vs. replacement sales. While repair sales typically carry attractive gross margins, the related revenue opportunity is an order of magnitude lower than an equipment sale.

- **Cyclical trends less favorable.** We believe that replacement demand will also wane in coming periods as the industry laps the dramatic declines following the bursting of the housing bubble.

- **Possible margin headwinds.** Management has highlighted likely price/cost headwinds in 2020, recent acquisitions and greenfields are initially margin-dilutive, and technology spending has continued to increase.

- **Technology investments should position WSO well in the long term.** Technology spending continues to rise gradually, including funding losses for the Alert Labs IoT investment. While additional spending remains a possibility should attractive return opportunities present themselves, we believe technology-related investments will more visibly improve WSO's sales and operational efficiency over the long term.

- **Recent results and trends.** 1Q20 EPS of $0.72 came in well below our $1.01 estimate driven by +2% same-store sales, lower gross margins (~50bps y/y), and investment/M&A-related expense growth.

Long-term thesis:

- **Leading market position.** WSO has become by far the No. 1 independent distributor of HVAC equipment and supplies, through a combination of organic growth, acquisitions, and joint ventures. We believe WSO will continue to take market share from the fragmented group of 1,300+ HVAC distributors in the US given benefits of scale (higher rebates, better sourcing, management resources, breadth of products, new technology tools, etc.), and driven by recent investment spending.

- **Higher ASPs.** Several developments in the HVAC market should drive higher average selling prices over the long-term including secular proliferation of environmentally friendly refrigerants and higher-efficiency products. The cyclical shift from repair to replace is also favorable for ASPs, although equipment has somewhat lower gross margins than parts and supplies. Higher commodities prices and other tariff-related increases drove strong pricing gains in 2018, including an unprecedented mid-year price increase.

- **Acquisition and JV opportunities.** Historically acquisitive, WSO had increasingly focused on larger transactions (i.e. companies with $100+ million in sales) in the Sunbelt this decade, but has more recently targeted companies that are both relatively smaller and outside of the sunbelt. WSO is a disciplined acquirer, rarely paying above 7x EBITDA, with additional JV opportunities with other HVAC OEMs always a possibility for step-function growth as well.

Risks & Caveats

- **Seasonality.** Sales of WSO's HVAC/R equipment and parts are seasonal, with sales strongest in the second and third quarters. These periods coincide with construction activity and, more importantly for Watsco, high usage of air-conditioning equipment results in greater servicing needs.

- **Weather influence.** Given that 85% of WSO's residential HVAC/R product sales are of a replacement nature, the company's sales and profits can be impacted by changes in temperature in some markets. Unusually hot weather can lead to greater air conditioning usage and higher repair and replacement demand, although focus on the US Sun Belt mitigates the impact of weather significantly.

- **Dividend payout ratio.** Distributions to non-controlling interest, which totaled approximately $47 million in 2018, are categorized under GAAP as a financing cash flow. Going forward, however, we have elected to include these amounts in "adjusted" free cash flow, which in our opinion provides a better gauge of WSO’s cash available for dividend financing. Using this methodology, we expect 2020 and 2021 payout ratios in the range of 90-100%+ of adjusted free cash flow.

- **Ownership concentration.** Albert Nahmad, CEO, controls more than 50% of the aggregate voting power across both classes of common stock and has the power to elect six of nine board members.

- **Manufacturer's terms and conditions.** WSO purchases ~70% of its product from just two manufacturers (Carrier and Rheem). WSO feels that its relationship with these manufacturers is in good standing and has long-term distribution agreements that provide a degree of exclusive distribution rights for each vendor. If there were an interruption in the production or delivery from any of these manufacturers, it could materially impact WSO's performance.
Appendix - Important Disclosures and Analyst Certification

Approved on 29 May 2020 10:48EDT/ Published on 29 May 2020 10:53EDT.

Rating and Price Target History for: Watsco, Inc. (WSO) as of 05-28-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of WSO.

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Watsco, Inc.
May 29, 2020

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