
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities and Exchange Act of 1934

For the Fiscal Year Ended December 31, 2020

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

watsco

WATSCO, INC.

(Exact name of registrant as specified in its charter)

FLORIDA
(State or other jurisdiction of
incorporation or organization)

59-0778222
(I.R.S. Employer
Identification No.)

2665 South Bayshore Drive, Suite 901
Miami, FL 33133
(Address of principal executive offices, including zip code)

(305) 714-4100
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common stock, \$0.50 par value	WSO	New York Stock Exchange
Class B common stock, \$0.50 par value	WSOB	New York Stock Exchange

Securities registered pursuant to section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 and 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 every Interactive Data File required to be submitted 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 such files). Yes No

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

Large accelerated filer
Non-accelerated filer

Accelerated filer
Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant has filed a report on and attestation to its management's assessment of the effectiveness of its internal control over financial reporting under Section 404(b) of the Sarbanes-Oxley Act (15 U.S.C. 7262(b)) by the registered public accounting firm that prepared or issued its audit report.

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

The aggregate market value of the registrant's voting common equity held by non-affiliates of the registrant as of June 30, 2020, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$5,937 million, based on the closing sale price of the registrant's common stock on that date. For purposes of determining this number, all named executive officers and directors of the registrant as of June 30, 2020 were considered affiliates of the registrant. This number is provided only for the purposes of this Annual Report on Form 10-K and does not represent an admission by either the registrant or any such person as to the affiliate status of such person.

The registrant's common stock outstanding as of February 23, 2021 comprised (i) 32,868,790 shares of Common stock, excluding 4,823,988 treasury shares, and 5,743,626 shares of Class B common stock, excluding 48,263 treasury shares.

DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part II is incorporated by reference from the registrant's 2020 Annual Report, attached hereto as Exhibit 13. The information required by Part III (Items 10, 11, 12, 13, and 14) is incorporated herein by reference from the registrant's definitive proxy statement for the 2021 annual meeting of shareholders (to be filed pursuant to Regulation 14A).

WATSCO, INC. AND SUBSIDIARIES

Form 10-K
For the Fiscal Year Ended December 31, 2020

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PART I

Forward-Looking Statements

This Annual Report on Form 10-K 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. Statements which are not historical in nature, including the words “anticipate,” “estimate,” “could,” “should,” “may,” “plan,” “seek,” “expect,” “believe,” “intend,” “target,” “will,” “project,” “focused,” “outlook,” “goal,” “designed,” and variations of these words and negatives thereof and similar expressions are intended to identify forward-looking statements, including statements regarding, among others, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions and/or joint ventures and investments in unconsolidated entities, (iv) financing plans, and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based on management’s current expectations, are not guarantees of future performance and are subject to a number of risks, uncertainties, and changes in circumstances, certain of which are beyond our control. Actual results could differ materially from these forward-looking statements as a result of several factors, including, but not limited to:

- *general economic conditions, both in the United States and in the international markets we serve;*
- *competitive factors within the HVAC/R industry;*
- *effects of supplier concentration;*
- *fluctuations in certain commodity costs;*
- *consumer spending;*
- *consumer debt levels;*
- *the continued impact of the COVID-19 pandemic;*
- *new housing starts and completions;*
- *capital spending in the commercial construction market;*
- *access to liquidity needed for operations;*
- *seasonal nature of product sales;*
- *weather patterns and conditions;*
- *insurance coverage risks;*
- *federal, state, and local regulations impacting our industry and products;*
- *prevailing interest rates;*
- *foreign currency exchange rate fluctuations;*
- *international risk;*
- *cybersecurity risk; and*
- *the continued viability of our business strategy.*

We believe these forward-looking statements are reasonable; however, you should not place undue reliance on any forward-looking statements, which are based on current expectations. For additional information regarding important factors that may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, please see the discussion included in Item 1A “Risk Factors” of this Annual Report on Form 10-K, as well as the other documents and reports that we file with the SEC. Forward-looking statements speak only as of the date the statements were 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, except as required by applicable law. We qualify any and all of our forward-looking statements by these cautionary factors.

ITEM 1. BUSINESS

General

Watsco, Inc. and its subsidiaries (collectively, “Watsco,” or “we,” “us,” or “our”) was incorporated in Florida 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 in North America. At December 31, 2020, we operated from 600 locations in 38 U.S. States, Canada, Mexico and Puerto Rico with additional market coverage on an export basis to portions of Latin America and

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the Caribbean, through which we serve more than 100,000 active contractors and dealers that service the replacement and new construction markets. Our revenues in HVAC/R distribution have increased from \$64.1 million in 1989 to \$5.1 billion in 2020, resulting from our strategic acquisition of companies with established market positions and subsequent building of revenues and profit through a combination of additional locations, introduction of new products, and other initiatives.

Our principal executive office is located at 2665 South Bayshore Drive, Suite 901, Miami, Florida 33133, and our telephone number is (305) 714-4100. Our website address on the Internet is www.watsco.com and e-mails may be sent to info@watsco.com. Our website address is included in this report only as an inactive textual reference. Information contained on, or available through, our website is not incorporated by reference in, or made a part of, this report.

Air Conditioning, Heating and Refrigeration Industry

The HVAC/R distribution industry is highly fragmented with approximately 2,100 distribution companies. The industry in the United States and Canada is well-established, having had its primary period of growth during the post-World War II era with the advent of affordable central air conditioning and heating systems for both residential and commercial applications. The advent of HVAC/R products in Latin America and the Caribbean is also well-established but has emerged in more recent years as those economies have grown and products have become more affordable and have matured from luxury to necessity.

Based on data published in the 2019 IBIS World Industry Report for Heating and Air Conditioning Contractors in the U.S. and other available data, we estimate that the annual market on an installed basis for residential central air conditioning, heating, and refrigeration equipment, and related parts and supplies is approximately \$97.0 billion. Air conditioning and heating equipment is manufactured primarily by seven major companies that together account for approximately 90% of all units shipped in the United States each year. These companies are: Carrier Global Corporation (“Carrier”); Goodman Manufacturing Company, L.P. (“Goodman”), a subsidiary of Daikin Industries, Ltd.; Rheem Manufacturing Company (“Rheem”); Trane Technologies Inc. (“Trane”); York International Corporation, a subsidiary of Johnson Controls, Inc.; Lennox International, Inc.; and Nortek Global HVAC, LLC (“Nortek”), a subsidiary of Nortek, Inc. These manufacturers distribute their products through a combination of factory-owned locations and independent distributors who, in turn, supply the equipment and related parts and supplies to contractors and dealers that sell to and install the products for consumers, businesses, and other end-users.

Air conditioning and heating equipment is sold to the replacement and new construction markets for both residential and commercial applications. The residential replacement market has increased in size and importance over the past several years as a result of the aging of the installed base of residential central air conditioners and furnaces, the introduction of new higher energy efficient models to address both regulatory mandates as well as consumer optionality, the remodeling and expansion of existing homes, the addition of central air conditioning to homes that previously had only heating products, and consumers’ overall unwillingness to live without air conditioning or heating products. The mechanical life of central air conditioning and furnaces varies by geographical region due to usage and ranges from approximately 8 to 20 years. According to data published by the Energy Information Administration in 2018 there are approximately 91 million central air conditioning and heating systems installed in the United States that have been in service for more than 10 years. Many installed units are currently reaching the end of their useful lives, which we believe long-term provides a growing and stable replacement market.

Additionally, we sell a variety of non-equipment products including parts, ductwork, air movement products, insulation, tools, installation supplies, thermostats, and air quality products. We distribute products manufactured by Flexible Technologies, Inc. (“Flexible Technologies”), Resideo Technologies Inc. (“Resideo”), Southwark Metal Mfg. Co. (“Southwark”), Johns Manville (“Johns Manville”) and Owens Corning Insulating Systems, LLC (“Owens Corning”), among others.

We also sell products to the commercial refrigeration market. These products include condensing units, compressors, evaporators, valves, refrigerant, walk-in coolers, and ice machines for industrial and commercial applications. We distribute products manufactured by Copeland Corporation, LLC, a subsidiary of Emerson Electric Co. (“Emerson”), The Chemours Company (“Chemours”), Mueller Industries, Inc. (“Mueller”), and Welbilt, Inc. (“Welbilt”), among others.

Culture and Business Strategy

Watsco began its HVAC/R distribution strategy in 1989 and has grown by using a “buy and build” philosophy, resulting in substantial long-term growth in revenues and profits. The “buy” component of the strategy has focused on acquiring or investing in market leaders to either expand into new geographic areas or gain additional market share in existing markets. We have employed a disciplined and conservative approach, which seeks opportunities that fit well-defined financial and strategic criteria. The “build” component of the strategy has focused on encouraging growth at acquired companies, by adding products and locations to better serve customers, investing in scalable technologies, and exchanging ideas and

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business concepts amongst leadership teams. Newly acquired businesses have access to our capital resources and established vendor relationships to provide their customers with an expanded array of product lines on favorable terms and conditions with an intensified commitment to service. We have also developed a culture whereby leaders, managers and employees are provided the opportunity to own shares of Watsco through a variety of stock-based equity plans. We believe that this culture instills a performance-driven, long-term focus on the part of our employees and aligns their interests with the interests of other Watsco shareholders.

Culture of Innovation & Technology Strategy

In recent years, we have established a strong culture of innovation, whereby people, processes and technology have rapidly evolved to modernize and digitize our business. With this digital evolution in mind, our efforts have addressed how customers are served, how internal processes and practices can be improved, and how data and analytics can be created and used to enhance long-term performance. Investments include the addition of more than 200 technology employees along with investments in our locations and infrastructure to enable these technologies.

To that end, several scalable technology platforms have been launched with the largest focus on customer-obsessed technologies, which are improving and transforming the customer experience at all of our locations. Specific initiatives include: (i) mobile applications for iOS and Android devices to help customers operate more efficiently and interact with our locations more easily; (ii) e-commerce between our customers and our subsidiaries; (iii) supply chain optimization; (iv) building and maintaining the largest source of digitized HVAC/R product information; and (v) the development of business intelligence systems and related data sets, which provide enhanced management tools. In addition, through our subsidiary Watsco Ventures, LLC (“Watsco Ventures”), we have developed (internally and through external collaboration) a variety of early-stage technologies with the goal of helping contractor customers grow and become more profitable, and otherwise compliment the initiatives set forth above.

Strategy in Existing Markets

Our strategy for growth in existing markets focuses on customer service, product expansion, and the implementation of technology to satisfy the needs of the higher growth, higher margin replacement market, in which customers generally demand immediate, convenient, and reliable service. We respond to this need by (i) offering a broad range of product lines, including the necessary equipment at an array of price-points, parts, and supplies to enable a contractor to install or repair a central air conditioner, furnace, or refrigeration system, (ii) maintaining a strong density of warehouse locations for increased customer convenience, (iii) maintaining well-stocked inventories to ensure that customer orders are filled in a timely manner, (iv) providing a high degree of technical expertise at the point of sale, (v) collaborating with customers to advertise and market their business and services in local markets, and (vi) developing and implementing technology to further enhance customer service capabilities. We believe these concepts provide a competitive advantage over smaller, less-capitalized competitors that are unable to commit resources to open and maintain additional locations, implement technological business solutions, provide the same range of products, maintain the same inventory levels, or attract the wide range of expertise that is required to support a diverse product offering. In some geographic areas, we believe we have a competitive advantage over factory-operated distribution networks, which typically do not maintain inventories of parts and supplies that are as diversified as ours and which have fewer warehouse locations than we do, making it more difficult for these competitors to meet the time-sensitive demands of the replacement market.

In addition to the replacement market, we sell to the new construction market, including new homes and commercial construction. We believe our reputation for reliable, high-quality service, and relationships with contractors, who may serve both the replacement and new construction markets, allows us to compete effectively in these markets.

Product Line Expansion

We actively seek new or expanded territories of distribution from our key equipment suppliers. We continually evaluate new parts and supply products to support equipment sales and further enhance service to our customers. This initiative includes increasing our product offering with existing vendors and identifying new product opportunities through traditional and non-traditional supply channels. We have also introduced private-label products as a means to obtain market share and grow revenues. We believe that our private-label branded products complement our existing product offerings at selected locations, based on customer needs and the particular market position and price of these products.

Acquisition Strategy

We focus on acquiring and investing in businesses that either complement our current presence in existing markets or establish a presence in new geographic markets. Since 1989, we have acquired 63 HVAC/R distribution businesses, some of which currently operate as primary operating subsidiaries. Other smaller acquired distributors have been integrated into or are under the management of our primary operating subsidiaries. Through a combination of sales and market share growth,

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opening of new locations, tuck-in acquisitions, expansion of product lines, improved pricing, and programs that have resulted in higher gross profit, performance incentives, and a culture of equity value for key leadership, we have produced substantial sales and earnings growth in our acquired businesses. We continue to pursue additional strategic acquisitions, investments and joint ventures to allow further penetration in existing markets and expansion into new geographic markets.

Operating Philosophy

We encourage our local leadership to operate in a manner that builds upon the long-term relationships they have established with their suppliers and customers. Typically, we maintain the identity of businesses by retaining their historical trade names, management teams and sales organizations, and continuity of their product brand-name offerings. We believe this strategy allows us to build on the value of the acquired operations by creating additional sales opportunities while providing an attractive exit strategy for the former owners of these companies.

We maintain a specialized staff at our corporate headquarters that provides functional support for our subsidiaries' growth strategies in their respective markets. Such functional support staff includes specialists in finance, accounting, product procurement, information technology, treasury and working capital management, tax planning, risk management, and safety. Certain general and administrative expenses are targeted for cost savings by leveraging the overall business volume and improving operating efficiencies.

Human Capital

As of December 31, 2020, we employed approximately 5,800 full-time employees, substantially all of whom were non-union employees. Of these employees, approximately 10% were located in Canada and Mexico. Additionally, we use independent contractors and temporary personnel in the normal course of business to supplement our workforce. As the largest distributor of HVAC/R equipment and related parts and supplies in North America, we have a wide variety of employees. Given the breadth of our employee base, we tailor our human capital management policies with a view to specific employee populations. However, we provide a wide variety of opportunities for professional growth and talent development for all employees, including online trainings, on-the-job experience, and education tuition assistance.

We focus on attracting and retaining employees by providing compensation and benefits programs that are competitive within our industry, taking into account each job position's location and responsibilities. In addition to salaries, commission programs, cash incentives, and stock-based equity plans, we also provide a 401(k) retirement plan with a company match, an employee stock purchase plan in which most of our employees may purchase our stock at a discount, healthcare and insurance benefits, health savings accounts, paid time off, and various services and tools to support our employees' health and wellness.

We maintain a culture that rewards performance of key leaders through stock-based equity plans, which include the granting of stock options and non-vested restricted stock based on individual merit and measures of performance. Approximately 150 employees received such equity awards in 2020. Our equity compensation plans are designed to promote long-term performance, as well as to create long-term employee retention, continuity of leadership, and an ownership culture whereby management and employees think and act as owners of the Company. We believe that our restricted stock program is unique because an employee's restricted share grants generally vest entirely and only at the end of his or her career (age 62 or later) and, prior to retirement, these grants remain subject to significant risk of forfeiture.

DESCRIPTION OF BUSINESS

Products

We sell an expansive line of products and maintain a diverse mix of inventory to meet our customers' immediate needs, and we seek to provide products a contractor would generally require when installing or repairing a central air conditioner, furnace, or refrigeration system on short notice. The cooling capacity of air conditioning units is measured in tons. One ton of cooling capacity is equivalent to 12,000 British Thermal Units ("BTUs") and is generally adequate to air condition approximately 500 square feet of residential space. The products we distribute consist of: (i) equipment, including residential ducted and ductless air conditioners ranging from 1 to 5 tons, gas, electric, and oil furnaces ranging from 50,000 to 150,000 BTUs, commercial air conditioning and heating equipment systems ranging from 1-1/2 to 25 tons, and other specialized equipment, (ii) parts, including replacement compressors, evaporator coils, motors, and other component parts, (iii) supplies, including thermostats, insulation material, refrigerants, ductwork, grills, registers, sheet metal, tools, copper tubing, concrete pads, tape, adhesives, and other ancillary supplies and (iv) plumbing and bathroom remodeling supplies.

Sales of HVAC equipment, which we currently source from approximately 20 vendors, accounted for 69% and 68% of our revenues for the years ended December 31, 2020 and 2019, respectively. Sales of other HVAC products, which we currently source from approximately 1,200 vendors, comprised 28% of our revenues for both the years ended December 31, 2020 and 2019. Sales of commercial refrigeration products, which we currently source from approximately 150 vendors, accounted for 3% and 4% of our revenues for the years ended December 31, 2020 and 2019, respectively.

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Distribution and Sales

At December 31, 2020, we operated from 600 locations, a vast majority of which are located in regions that we believe have demographic trends favorable to our business. We maintain large inventories at each of our warehouse locations and either deliver products to customers using our trucks or third-party logistics providers, or we make products available for pick-up at the location nearest to the particular customer. We have approximately 1,000 salespeople, averaging 10 years of experience in the HVAC/R distribution industry.

<u>The markets we serve are as follows:</u>	<u>% of Revenues for the Year Ended December 31, 2020</u>	<u>Number of Locations as of December 31, 2020</u>
United States	90%	541
Canada	6%	36
Latin America and the Caribbean	4%	23
Total	100%	600

The largest market we serve is the United States, in which the most significant markets for HVAC/R products are in the Sun Belt states. Accordingly, the majority of our distribution locations are in the Sun Belt, with the highest concentration in Florida and Texas. These markets have been a strategic focus of ours given their size, the reliance by homeowners and businesses on HVAC/R products to maintain a comfortable indoor environment, and the population growth in these areas over the last 40 years, which has led to a substantial installed base requiring replacement, a shorter useful life for equipment given the significant hours of operation, and the focus by electrical utilities on consumer incentives designed to promote replacement of HVAC/R equipment in an effort to improve energy efficiency.

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Markets

The table below identifies the number of our stores by location as of December 31, 2020:

Florida	100
Texas	83
North Carolina	45
California	36
Georgia	33
South Carolina	31
Virginia	24
Tennessee	22
Louisiana	18
New York	18
Pennsylvania	15
New Jersey	14
Alabama	10
Arizona	9
Connecticut	9
Massachusetts	9
Mississippi	8
Missouri	8
Kansas	6
Maryland	6
Oklahoma	5
Utah	5
Arkansas	4
Indiana	2
Iowa	2
Kentucky	2
Maine	2
Nebraska	2
Nevada	2
South Dakota	2
West Virginia	2
Colorado	1
Delaware	1
New Hampshire	1
New Mexico	1
North Dakota	1
Rhode Island	1
Vermont	1
United States	541
Canada	36
Mexico	12
Puerto Rico	11
Total	<u>600</u>

Joint Ventures with Carrier Global Corporation

On April 3, 2020, United Technologies Corporation completed the spin-off of Carrier Corporation into an independent, publicly traded company, named Carrier Global Corporation (“Carrier”).

In 2009, we formed a joint venture with Carrier, which we refer to as Carrier Enterprise I, in which Carrier contributed 95 of its company-owned locations in 13 Sun Belt states and Puerto Rico, and its export division in Miami, Florida, and we contributed 15 locations that distributed Carrier products. We have an 80% controlling interest in Carrier Enterprise I, and

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Carrier has a 20% non-controlling interest. The export division, Carrier InterAmerica Corporation, redomesticated from the U.S. Virgin Islands to Delaware effective December 31, 2019, following which Carrier InterAmerica Corporation became a separate operating entity in which we have an 80% controlling interest and Carrier has a 20% non-controlling interest. On August 1, 2019, Carrier Enterprise I acquired substantially all of the HVAC assets and assumed certain of the liabilities of Peirce-Phelps, Inc. (“PPI”), an HVAC distributor operating from 19 locations in Pennsylvania, New Jersey, and Delaware.

In 2011, we formed a second joint venture with Carrier, in which Carrier contributed 28 of its company-owned locations in the Northeast U.S., and we contributed 14 locations in the Northeast U.S., and we then purchased Carrier’s distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have an 80% controlling interest in Carrier Enterprise II, and Carrier has a 20% non-controlling interest. Effective May 31, 2019, we purchased an additional 20% ownership interest in Homans Associates II LLC (“Homans”) from Carrier Enterprise II, following which we owned 100% of Homans. Homans previously operated as a division of Carrier Enterprise II and now operates as one of our stand-alone, wholly owned subsidiaries.

In 2012, we formed a third joint venture with Carrier, which we refer to as Carrier Enterprise III. Carrier contributed 35 of its company-owned locations in Canada to Carrier Enterprise III. We have a 60% controlling interest in Carrier Enterprise III, and Carrier has a 40% non-controlling interest.

Combined, the joint ventures with Carrier represented 55% of our revenues for the year ended December 31, 2020. See *Supplier Concentration* in “Business Risk Factors” in Item 1A.

The business and affairs of the joint ventures are controlled, directed, and managed exclusively by Carrier Enterprise I’s, Carrier Enterprise II’s and Carrier Enterprise III’s respective boards of directors (the “Boards”) pursuant to related operating agreements. The Boards have full, complete and exclusive authority, power, and discretion to manage and control the business, property, and affairs of their respective joint ventures, and to make all decisions regarding those matters and to perform activities customary or incident to the management of such joint ventures, including approval of distributions to us and Carrier. Each Board is composed of five directors, of whom three directors represent our controlling interest and two directors represent Carrier’s non-controlling interest. Matters presented to the Boards for vote are considered approved or consented to upon the receipt of the affirmative vote of at least a majority of all directors entitled to vote with the exception of certain governance matters, which require joint approval.

Customers and Customer Service

Air conditioning and heating contractors and dealers that install HVAC/R products in homes and businesses must be licensed given the highly regulated nature of the products, refrigerant, natural gas, and building and zoning requirements. We currently serve more than 100,000 active contractors and dealers who service the replacement and new construction markets for residential and light commercial central air conditioning, heating, and refrigeration systems. No single customer in 2020, 2019 or 2018 represented more than 2% of our consolidated revenues. We focus on providing products where and when the customer needs them, technical support by phone or on site as required, and quick and efficient service at our locations. Increased customer convenience is also provided through mobile applications and e-commerce, which allows customers to access information online 24 hours a day, seven days a week to search for desired products, verify inventory availability, obtain pricing, place orders, check order status, schedule pickup or delivery times, and make payments. We believe we compete successfully with other distributors primarily based on an experienced sales organization, strong service support, maintenance of well-stocked inventories, density of warehouse locations, high quality reputation, broad product lines, and the ability to foresee customer demand for new products.

Key Supplier Relationships

Given our leadership position, Watsco represents a strategic business relationship to many of the leading manufacturers in our industry. Significant relationships with HVAC/R equipment manufacturers include Carrier, Rheem, Goodman, Welbilt, Mitsubishi Electric Corporation, Gree Electric Appliances, Inc., Trane, Midea Group, and Nortek. In addition, we have substantial relationships with manufacturers of non-equipment HVAC/R products, including Chemours, Emerson, Flexible Technologies, Resideo, Southwark, Johns Manville, Mueller, and Owens Corning.

We believe the diversity of products that we sell, along with the manufacturers’ current product offerings, quality, marketability, and brand-name recognition, allow us to operate favorably relative to our competitors. To maintain brand-name recognition, HVAC/R equipment manufacturers provide national advertising and participate with us in cooperative advertising programs and promotional incentives that are targeted to both dealers and end-users. We estimate that the replacement market for residential air conditioning equipment is approximately 85% of industry unit sales in the United States, and we expect this percentage to increase as units installed in the past 20 years wear out or otherwise become practical to replace sooner with newer, more energy-efficient models.

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The Company's top ten suppliers accounted for 85% of our purchases, including 63% from Carrier, and 11% from Rheem. Given the significant concentration of our suppliers, particularly with Carrier and Rheem, any significant interruption with these suppliers, including limitations on the ability of our suppliers to manufacture, or procure from manufacturers, the products we sell, or to meet delivery requirements and commitments, in each case related to the COVID-19 pandemic, could temporarily disrupt the operations of certain of our subsidiaries, impact current inventory levels, and could adversely affect our financial results. If any restrictions or significant increase in tariffs under existing trade agreements are imposed on products that our top ten suppliers import or assemble outside of the United States, particularly from Mexico and China, we could be required to raise our prices, which may result in the loss of customers and harm to our business. Future financial results are also materially dependent upon the continued market acceptance of these manufacturers' respective products and their ability to continue to manufacture products that comply with laws relating to environmental and efficiency standards. However, the Company believes that alternative or substitute products would be readily available in the event of disruption of current supplier relationships given the Company's prominence in the marketplace, including the number of locations, sales personnel, support structure, marketing and sales expertise, financial position, and established market share. See "Business Risk Factors" in Item 1A of this Annual Report on Form 10-K for further discussion.

Distribution Agreements

We maintain trade name and distribution agreements with Carrier and Rheem that provide us distribution rights on an exclusive basis in specified territories and are not subject to a stated term or expiration date. We also maintain distribution agreements with various other suppliers, either on an exclusive or non-exclusive basis, for various terms ranging from one to ten years. Certain distribution agreements for particular branded products contain provisions that restrict or limit the sale of competitive products in the locations that sell such branded products. Other than where such location-level restrictions apply, we may distribute the lines of other manufacturers' air conditioning or heating equipment in other locations in the same territories.

See *Supplier Concentration* in "Business Risk Factors" in Item 1A of this Annual Report on Form 10-K.

Seasonality

Sales of residential central air conditioners, heating equipment, and parts and supplies are seasonal. Furthermore, profitability can be impacted favorably or unfavorably based on weather patterns, particularly during Summer and Winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the first and fourth quarters. Demand related to the new construction sectors throughout most of the markets we serve tends to be fairly evenly distributed throughout the year and depends largely on housing completions and related weather and economic conditions.

Competition

We operate in highly competitive environments. We compete with a number of distributors and also with several air conditioning and heating equipment manufacturers that distribute a significant portion of their products through their own distribution organizations in certain markets. Competition within any given geographic market is based upon product availability, customer service, price, and quality. Competitive pressures or other factors could cause our products or services to lose market acceptance or result in significant price erosion, all of which would have a material adverse effect on our results of operations, cash flows, and liquidity.

Order Backlog

Order backlog is not a material aspect of our business and no material portion of our business is subject to government contracts.

Government Regulations, Environmental and Health and Safety Matters

Our business is subject to federal, state and local laws, and regulations relating to the storage, handling, transportation, and release of hazardous materials into the environment. These laws and regulations include the Clean Air Act, relating to minimum energy efficiency standards of HVAC systems, and the production, servicing, and disposal of more environmentally friendly refrigerants used in such systems, including those established by the Kigali Amendment to the Montreal Protocol concerning the phase-down of the production of HFC-based refrigerants for use in new equipment. We are also subject to regulations concerning the transport of hazardous materials, including regulations adopted pursuant to the Motor Carrier Safety Act of 1990. Our operations are also subject to health and safety requirements including, but not limited to, the Occupational, Safety and Health Act. We believe that we operate our business in compliance with all applicable federal, state and local laws, and regulations.

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Our industry and business are also subject to United States Department of Energy (“DOE”) standards related to the minimum required efficiency levels of residential central air conditioning systems and heat pumps. For purposes of establishing these energy conservation standards, the DOE divides the United States into three regions (the North, the Southeast, and the Southwest) according to the number of hours that an air conditioner operates to cool a home during the hotter months. The seasonal energy efficiency rating, or SEER, is the metric used to measure HVAC energy efficiency. The higher the SEER, the more efficient the HVAC equipment. The current minimum SEER allowed for HVAC equipment is 13 SEER in the North and 14 SEER for the Southeast and Southwest regions. Beginning in 2023, the minimum efficiency level for residential HVAC systems under 45,000 BTUs will be 14 SEER in the North and 15 SEER in the Southeast and Southwest. For systems over 45,000 BTUs, the minimum efficiency level will be 14 SEER in the North and 14.5 SEER in the Southeast and Southwest. Heat pump efficiency levels will be set at 15 SEER for all three regions. It is too early to determine the impact to our results of operations this transition will have, however, we expect a benefit from selling higher efficiency units, which sell at higher prices.

During 2014, the DOE established new rules for the manufacturing of motors used in residential furnaces with the purpose of increasing the energy efficiency of these motors, and, consequently, the furnaces in which they operate. The mandate dictates that residential furnace fans manufactured in the United States on or after the effective date of July 3, 2019, must have a Fan Energy Rating (“FER”) value reduction of 12% or 46% in watts/cfm, depending on the type of furnace. To meet these new standards, most manufacturers have replaced the permanent split capacitor blower motors in residential furnaces with electronic controlled motors. At December 31, 2020, the transition of our inventory of residential furnaces to those meeting the updated FER standards was complete.

Available Information

Our website is at www.watsco.com. Our investor relations website is located at <https://investors.watsco.com>. We make available, free of charge, on our investor relations website under the heading “SEC Filings” our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to those reports filed with or furnished to the Securities and Exchange Commission (the “SEC”) pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. Our website address is included in this report only as an inactive textual reference. Information contained on, or available through, our website is not incorporated by reference in, or made a part of, this report.

ITEM 1A. RISK FACTORS

Business Risk Factors

COVID-19 Pandemic

A novel strain of coronavirus, COVID-19, surfaced in December 2019 and has spread around the world, including to the United States. In March 2020, the World Health Organization declared COVID-19 a pandemic. The COVID-19 pandemic adversely impacted our operations in March and April 2020 and could continue to adversely affect our business and results of operations, including as government authorities impose or reimpose mandatory closures, work-from-home orders and social distancing protocols, or impose other restrictions due to the continued high rate of viral infections that exist as of this date. These actions could materially adversely affect our ability to adequately staff and maintain our operations, interrupt our supply lines, impair our ability to sustain sufficient financial liquidity and adversely impact our financial results.

COVID-19 related factors that have impacted us, or may negatively impact, sales, gross margin and other results of operations in the future include, but are not limited to: limitations on the ability of our suppliers to manufacture, or procure from manufacturers, the products we sell, or to meet delivery requirements and commitments; limitations on the ability of our employees to perform their work due to illness or other disruptions caused by the pandemic, including local, state, or federal orders requiring employees to remain at home; limitations on the ability of carriers to deliver our products to customers; limitations on the ability of our customers to conduct their businesses and purchase our products; and limitations on the ability of our customers to pay us on a timely basis. Moreover, the COVID-19 pandemic could alter the mix of our business due to a shift in consumer demand towards repair of equipment rather than replacement, as well as changes in our sales mix toward value-oriented equipment and lower demand and/or disruption to new construction and commercial markets, which would result in a reduction in our sales and consequential gross margin.

As we cannot predict the duration or scope of the COVID-19 pandemic in the future, the potential negative financial impact to our results of operations cannot be reasonably estimated but could be material and last for an extended period of time.

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Supplier Concentration

The Company's top ten suppliers accounted for 85% of our purchases during 2020, including 63% from Carrier, and 11% from Rheem. Carrier provides a diverse variety of brands of HVAC systems including, Carrier, Bryant, Payne, Tempstar, Heil, Comfortmaker and Grandaire, along with complimentary replacement parts. Rheem provides Rheem-brand HVAC systems along with complimentary replacement parts. Given the significant concentration of our supply chain, particularly with Carrier and Rheem, any significant interruption by any of the key manufacturers or a termination of a relationship could temporarily disrupt the operations of certain of our subsidiaries. Additionally, our operations are materially dependent upon the continued market acceptance and quality of these manufacturers' products and their ability to continue to manufacture products that are competitive and that comply with laws relating to environmental and efficiency standards. Our inability to obtain products from one or more of these manufacturers or a decline in market acceptance of these manufacturers' products could have a material adverse effect on our results of operations, cash flows, and liquidity.

Many HVAC equipment and component manufacturers, including Carrier and Rheem, source component parts from China and/or assemble a significant amount of products for residential and light-commercial applications from Mexico. If any restrictions, including a potential increase in tariffs, are imposed related to such products sourced or assembled from Mexico and China, including as a result of amendments to existing trade agreements, and our product costs consequently increase, we would be required to raise our prices, which may result in cost inflation, the loss of customers, and harm to our business. In addition, COVID-19, which surfaced in Wuhan, China in December 2019, resulted in increased travel restrictions and extended shutdown of certain businesses in the region. The continuing impact of COVID-19 on our business will depend on future developments; however, closures in China and/or Mexico may disrupt the operations of certain of our suppliers, which could negatively impact our business.

We maintain trade name and distribution agreements with Carrier and Rheem that provide us distribution rights on an exclusive basis in specified territories. Such agreements are not subject to a stated term or expiration date.

We also maintain other distribution agreements with various other suppliers, either on an exclusive or non-exclusive basis, for various terms ranging from one to ten years. Certain of the distribution agreements contain provisions that restrict or limit the sale of competitive products in the locations that sell such branded products. Other than where such location-level restrictions apply, we may distribute other manufacturers' lines of air conditioning or heating equipment in other locations in the same territories.

Risks Inherent in Acquisitions

As part of our strategy, we intend to pursue additional acquisitions of complementary businesses, including through joint ventures and investments in unconsolidated entities. If we complete future acquisitions, including investments in unconsolidated entities, or enter into new joint ventures, we may be required to incur or assume additional debt and/or issue additional shares of our common stock as consideration, which will dilute our existing shareholders' ownership interest and may affect our results of operations. Growth through acquisitions involves a number of risks, including, but not limited to, the following:

- the ability to identify and consummate transactions with complementary acquisition candidates;
- the successful operation and/or integration of acquired companies;
- diversion of management's attention from other daily functions;
- issuance by us of equity securities that would dilute ownership of our existing shareholders;
- incurrence and/or assumption of significant debt and contingent liabilities; and
- possible loss of key employees and/or customer relationships of the acquired companies.

In addition, acquired companies and investments made in unconsolidated entities may have liabilities that we failed or were unable to discover while performing due diligence investigations. We cannot assure you that the indemnification, if any, granted to us by sellers of acquired companies or by joint venture partners will be sufficient in amount, scope, or duration to offset the possible liabilities associated with businesses or properties that we assume upon consummation of an acquisition or joint venture. Any such liabilities, individually or in the aggregate, could have a material adverse effect on our business.

Failure to successfully manage the operational challenges and risks associated with, or resulting from, acquisitions could adversely affect our results of operations, cash flows, and liquidity.

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Competition

We operate in highly competitive environments. We compete with other distributors and several air conditioning and heating equipment manufacturers that distribute a significant portion of their products through their own distribution organizations in certain markets. Competition within any given geographic market is based upon product availability, customer service, price, and quality. Competitive pressures or other factors could cause our products or services to lose market acceptance or result in significant price erosion, all of which would have a material adverse effect on our results of operations, cash flows, and liquidity.

Foreign Currency Exchange Rate Fluctuations

The functional currency of our operations in Canada is the Canadian dollar, and the functional currency of our operations in Mexico is the U.S. dollar because the majority of our Mexican transactions are denominated in U.S. dollars. Foreign currency exchange rates and fluctuations may have an impact on transactions denominated in Canadian dollars and Mexican Pesos, and, therefore, could adversely affect our financial performance. Although we use foreign currency forward contracts to mitigate the impact of currency exchange rate movements, we do not currently hold any derivative contracts that hedge our foreign currency translational exposure.

Seasonality

Sales of residential central air conditioners, heating equipment, and parts and supplies are seasonal, resulting in fluctuations in our revenue from quarter to quarter. Furthermore, profitability can be impacted favorably or unfavorably based on the severity or mildness of weather patterns during Summer or Winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the first and fourth quarters. Demand related to the new construction sectors throughout most of the markets is fairly evenly distributed throughout the year and depends largely on housing completions and related weather and economic conditions.

Dependence on Key Personnel

Much of our success has depended on the skills and experience of senior management personnel. The loss of any of our executive officers or other key senior management personnel could harm our business. We must continuously recruit, retain, and motivate management and other employees to both maintain our current business and to execute our strategic initiatives. Our success has also depended on the contributions and abilities of our store employees upon whom we rely to give customers a superior in-store experience. Accordingly, our performance depends on our ability to recruit and retain high quality employees to work in and manage our stores. If we are unable to adequately recruit, retain, and motivate employees our projected growth and expansion, and our business and financial performance may be adversely affected.

Decline in Economic Conditions

We rely predominantly on the credit markets and, to a lesser extent, on the capital markets to meet our financial commitments and short-term liquidity needs if internal funds are not available from our operations. Access to funds under our line of credit is dependent on the ability of the syndicate banks to meet their respective funding commitments. Disruptions in the credit and capital markets could adversely affect our ability to draw on our revolving credit agreement and may also adversely affect the determination of interest rates, particularly rates based on LIBOR, which is one of the base rates under our revolving credit agreement. LIBOR is the subject of recent proposals for reform that currently provide for the phase-out of LIBOR after December 31, 2021. The consequences of these developments with respect to LIBOR cannot be entirely predicted but could result in an increase in the cost of our debt, as it is currently anticipated that lenders will replace LIBOR with an alternative rate that may exceed what would have been the comparable LIBOR rate. Additionally, disruptions in the credit and capital markets could also result in increased borrowing costs and/or reduced borrowing capacity under our revolving credit agreement. Any long-term disruption could require us to take measures to conserve cash until the markets stabilize, or until alternative credit arrangements or other funding for our business needs can be arranged. Such measures could include reducing or eliminating dividend payments, deferring capital expenditures, and reducing or eliminating other discretionary uses of cash.

A decline in economic conditions and lack of availability of business and consumer credit could have an adverse effect on our business and results of operations. Any capital or credit market disruption could cause broader economic downturns, which may lead to reduced demand for our products and an increased incidence of customers' inability to pay their accounts. Further, bankruptcies or similar events by customers may cause us to incur increased levels of bad debt expense. Also, our suppliers may be negatively impacted by deteriorating economic conditions, causing disruption or delay of product availability. These events would adversely impact our results of operations, cash flows, and financial position. Additionally, if the conditions of the capital and credit markets adversely affect the financial institutions that have committed to extend us credit, they may be unable to fund borrowings under such commitments, which could have an adverse impact on our financial condition, liquidity, and our ability to borrow funds for working capital, acquisitions, capital expenditures, and other corporate purposes.

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Cybersecurity Risks

In addition to the disruptions that may occur from interruptions in our information technology systems, cybersecurity threats and sophisticated and targeted cyberattacks pose a risk to our information technology systems. We have established security policies, processes and defenses designed to help identify and protect against intentional and unintentional misappropriation or corruption of our information technology systems and information and disruption of our operations. Despite these efforts, our information technology systems may be damaged, disrupted or shut down due to attacks by unauthorized access, malicious software, computer viruses, undetected intrusion, hardware failures or other events, and in these circumstances our disaster recovery plans may be ineffective or inadequate. These breaches or intrusions could lead to business interruption, exposure of proprietary or confidential information, data corruption, damage to our reputation, exposure to legal and regulatory proceedings and other costs. Such events could have a material adverse impact on our financial condition, results of operations and cash flows. In addition, we could be adversely affected if any of our significant customers or suppliers experiences any similar events that disrupt their business operations or damage their reputation.

We maintain monitoring practices and protections of our information technology to reduce these risks and test our systems on an ongoing basis for potential threats. The Audit Committee is briefed on information security matters at least once a year. We carry cybersecurity insurance to help mitigate the financial exposure and related notification procedures in the event of intentional intrusion. There can be no assurance, however, that our efforts will prevent the risk of a security breach of our databases or systems that could adversely affect our business.

International Risk

Our international sales and operations, as well as sourcing of products from suppliers with international operations, are subject to various risks associated with changes in local laws, regulations, and policies, including those related to tariffs, trade restrictions and trade agreements, investments, taxation, capital controls, employment regulations, different liability standards, and limitations on the repatriation of funds due to foreign currency controls. Our international sales and operations, as well as sourcing of products from suppliers with international operations, are also sensitive to changes in foreign national priorities, including government budgets, as well as political and economic instability. In addition, closures in China and Mexico due to COVID-19 may disrupt the operations of certain of our suppliers, which could negatively impact our business. Unfavorable changes in any of the foregoing could adversely affect our results of operations or could cause a disruption in our supply chain for products sourced internationally. Additionally, failure to comply with the United States Foreign Corrupt Practices Act could subject us to, among other things, penalties and legal expenses that could harm our reputation and have a material adverse effect on our business, financial condition, and results of operations.

Risks Related to our Common Stock

Class B Common Stock and Insider Ownership

As of December 31, 2020, our directors and executive officers and entities affiliated with them owned (i) Common stock representing 1% of the outstanding shares of Common stock and (ii) Class B common stock representing 84% of the outstanding shares of Class B common stock. These interests represent 53% of the aggregate combined voting power (including 51% beneficially owned by Albert H. Nahmad, Chairman and Chief Executive Officer, and Aaron J. Nahmad, President, through shares owned by them and shares held by affiliated limited partnerships and various family trusts). Accordingly, our directors and executive officers collectively have the voting power to elect six members of our nine-person Board of Directors.

Our Class B common stock is substantially identical to our Common stock except: (i) Common stock is entitled to one vote on all matters submitted to a vote of our shareholders, and each share of Class B common stock is entitled to ten votes; (ii) shareholders of Common stock are entitled to elect 25% of our Board of Directors (rounded up to the nearest whole number), and Class B shareholders are entitled to elect the balance of the Board of Directors; (iii) cash dividends may be paid on Common stock without paying a cash dividend on Class B common stock, and no cash dividend may be paid on Class B common stock unless at least an equal cash dividend is paid on Common stock; and (iv) Class B common stock is convertible at any time into Common stock on a one-for-one basis at the option of the shareholder.

Future Sales

We are not restricted from issuing additional shares of our Common stock or Class B common stock (which we refer to together as common stock), including securities that are convertible into or exchangeable for, or that represent the right to receive, our common stock or any substantially similar securities in the future. We may issue shares of our common stock or other securities in one or more registered or unregistered offerings, and we may also issue our securities in connection with investments or acquisitions. The number of shares of our common stock issued in connection with any of the foregoing may result in dilution to holders of our common stock.

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Volatility

The market price of our common stock may be highly volatile and could be subject to wide fluctuations. Securities markets worldwide experience significant price and volume fluctuations. This market volatility, as well as general economic, market or political conditions, could reduce the market price of shares of our common stock in spite of our operating performance. The trading price of our common stock may be adversely affected due to a number of factors, most of which we cannot predict or control, such as the following:

- fluctuations in our operating results;
- a decision by the Board of Directors to reduce or eliminate cash dividends on our common stock;
- changes in recommendations or earnings estimates by securities analysts;
- general market conditions in our industry or in the economy as a whole; and
- political instability, natural disasters, war and/or events of terrorism.

Trading Liquidity

The trading market for our common stock is limited, and there can be no assurance that a more liquid trading market for our common stock will develop. There can be no assurance as to the liquidity of any market for our common stock, the ability of the holders of our common stock to sell any of their securities and the price at which the holders of our common stock will be able to sell such securities.

Payment of Dividends

The amount of any future dividends that we will pay, if any, will depend upon a number of factors. Future dividends will be declared and paid at the sole discretion of the Board of Directors and will depend upon such factors as cash flow generated by operations, profitability, financial condition, cash requirements, future prospects, and other factors deemed relevant by our Board of Directors. The right of our Board of Directors to declare dividends, however, is subject to the availability of sufficient funds under Florida law to pay dividends. In addition, our ability to pay dividends depends on certain restrictions in our credit agreement.

Securities Analyst Research and Reports

The trading markets for our common stock rely in part on the research and reports that industry or financial analysts publish about us or our business or industry. If one or more of the analysts who cover us downgrade our stock or our industry, or the stock of Carrier or any of our competitors, or publish negative or unfavorable research about our business, the price of our stock could decline. If one or more of these analysts cease coverage of us or fail to publish reports on us regularly, we could lose visibility in the market, which in turn could cause our stock price or trading volume to decline.

General Risk Factors

Goodwill, Intangibles and Long-Lived Assets

At December 31, 2020, goodwill, intangibles, and long-lived assets represented approximately 40% of our total assets. The recoverability of goodwill, indefinite lived intangibles, and long-lived assets is evaluated at least annually and when events or changes in circumstances indicate that the carrying amounts may not be recoverable. The identification and measurement of goodwill impairment involves the estimation of the fair value of our reporting unit and contains uncertainty because management must use judgment in determining appropriate assumptions to be used in the measurement of fair value. The estimates of fair value of our reporting unit, indefinite lived intangibles, and long-lived assets are based on the best information available as of the date of the assessment and incorporates management's assumptions about expected future cash flows and contemplates other valuation techniques. Future cash flows can be affected by changes in the industry, a declining economic environment, or market conditions. We cannot assure you that we will not suffer material impairments to goodwill, intangibles, or long-lived assets in the future.

Risks Related to Loss Contingencies

We carry general liability, comprehensive property damage, workers' compensation, health benefits, cybersecurity, and other insurance coverage that management considers adequate for the protection of its assets and operations at reasonable premiums. There can be no assurance that the coverage limits and related premiums of such policies will be adequate to cover claims, losses and expenses for lawsuits which have been, or may be, brought against us. A loss in excess of insurance coverage could have a material adverse effect on our financial position and/or profitability. Certain self-insurance risks for casualty insurance programs and health benefits are retained and reserves are established based on claims filed and estimates of claims incurred but not yet reported. Assurance cannot be provided that actual claims will not exceed present estimates.

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Exposure to catastrophic losses has been limited by maintaining excess and aggregate liability coverage and implementing stop-loss control programs.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

Our main properties include warehousing and distribution facilities, trucks, and administrative office space.

Warehousing and Distribution Facilities

At December 31, 2020, we operated 600 warehousing and distribution facilities across 38 U.S. states, Canada, Mexico, and Puerto Rico, having an aggregate of approximately 13.3 million square feet of space, of which approximately 13.1 million square feet is leased. The majority of these leases are for terms of three to five years. We believe that our facilities are sufficient to meet our present operating needs.

Trucks

At December 31, 2020, we operated 769 ground transport vehicles, including delivery and pick-up trucks, vans, and tractors. Of this number, 514 trucks were leased and the rest were owned. We believe that the present size of our truck fleet is adequate to support our operations.

Administrative Facilities

Senior management and support staff are located at various administrative offices in approximately 0.2 million square feet of space.

ITEM 3. LEGAL PROCEEDINGS

Information with respect to this item may be found in Note 19 to our audited consolidated financial statements contained in this Annual Report on Form 10-K under the caption "Litigation, Claims and Assessments," which information is incorporated by reference in this Item 3 of Part I of this Annual Report on Form 10-K.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Market Information

Our Common stock is listed on the New York Stock Exchange under the ticker symbol WSO, and our Class B common stock is listed on the New York Stock Exchange under the ticker symbol WSOB.

Holders

At February 23, 2021, there were 220 Common stock registered shareholders and 156 Class B common stock registered shareholders.

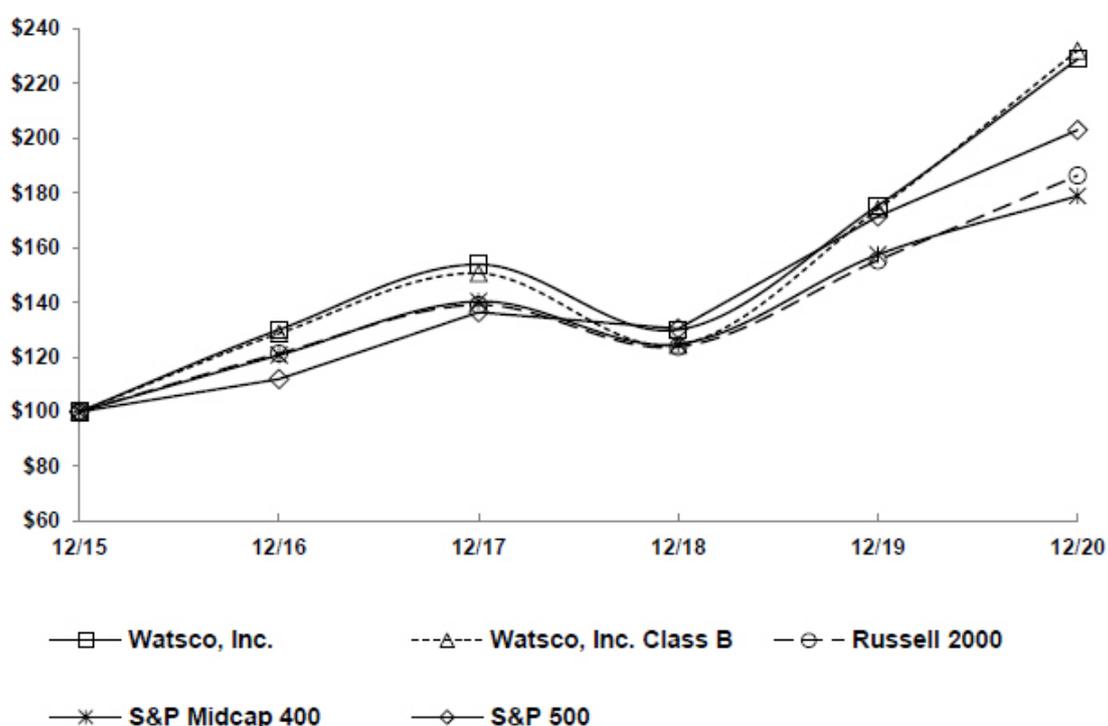
Shareholder Return Performance

The following graph compares the cumulative five-year total shareholder return attained by holders of our Common stock and Class B common stock relative to the cumulative total returns of the Russell 2000 index, the S&P MidCap 400 index, and the S&P 500 index. Given our position as the largest distributor of HVAC/R equipment, parts and supplies in North America, our unique, sole line of business, the nature of our customers (air conditioning and heating contractors), and the products and markets we serve, we cannot reasonably identify an appropriate peer group; therefore, we have included in the graph below the performance of the Russell 2000 index, the S&P MidCap 400 index, and the S&P 500 index, which contain companies with market capitalizations similar to our own. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each index on December 31, 2015 and its relative performance is tracked through December 31, 2020.

The performance graph shall not be deemed incorporated by reference by any general statement incorporating by reference this annual report into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934, except to the extent we specifically incorporate this information by reference, and shall not otherwise be deemed filed under such acts.

COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*

Among Watsco, Inc., the Russell 2000 Index, the S&P Midcap 400 Index and the S&P 500 Index



*\$100 invested on 12/31/15 in stock or index, including reinvestment of dividends. Fiscal year ending December 31.

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	12/31/15	12/31/16	12/31/17	12/31/18	12/31/19	12/31/20
Watsco, Inc.	100.00	130.00	153.87	129.98	175.41	228.94
Watsco Class B	100.00	128.63	150.64	124.43	174.08	203.06
Russell 2000 Index	100.00	121.31	139.08	123.76	155.35	186.36
S&P MidCap 400 Index	100.00	120.74	140.35	124.80	157.49	179.00
S&P 500 Index	100.00	111.96	136.40	130.42	171.49	203.04

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Purchases of Equity Securities by the Issuer and Affiliated Purchasers

In September 1999, our Board of Directors authorized the repurchase, at management's discretion, of up to 7,500,000 shares of common stock in the open market or via private transactions. No shares were repurchased under this plan during 2020, 2019 or 2018. In aggregate, 6,370,913 shares of Common and Class B common stock have been repurchased at a cost of \$114.4 million since the inception of this plan. At December 31, 2020, there were 1,129,087 shares remaining authorized for repurchase under this plan. Shares were last repurchased by the Company in 2008; thus, we did not otherwise repurchase any of our common stock during the quarter ended December 31, 2020.

ITEM 6. SELECTED FINANCIAL DATA

Our 2020 Annual Report contains "Selected Consolidated Financial Data," which section is incorporated herein by reference.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Our 2020 Annual Report contains "Management's Discussion and Analysis of Financial Condition and Results of Operations," which section is incorporated herein by reference.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our 2020 Annual Report contains "Quantitative and Qualitative Disclosures about Market Risk," which section is incorporated herein by reference.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our 2020 and 2019 Consolidated Balance Sheets and other consolidated financial statements for the years ended December 31, 2020, 2019 and 2018, together with the report thereon of KPMG LLP dated February 26, 2021, included in our 2020 Annual Report are incorporated herein by reference.

The 2020 and 2019 unaudited Selected Quarterly Financial Data appearing in our 2020 Annual Report is incorporated herein by reference.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. 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"), Executive Vice President ("EVP") and Chief Financial Officer ("CFO"), to allow for timely decisions regarding required disclosure and appropriate SEC filings.

Our management, with the participation of our CEO, EVP and CFO, 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, EVP and CFO concluded that our disclosure controls and procedures were effective, at a reasonable assurance level, at and as of such date.

Management's Report on Internal Control over Financial Reporting

Our 2020 Annual Report contains "Management's Report on Internal Control over Financial Reporting" and the report thereon of KPMG LLP dated February 26, 2021, and each is incorporated herein by reference.

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 were 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 December 31, 2020, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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ITEM 9B. OTHER INFORMATION

None.

PART III

This part of Form 10-K, which includes Items 10 through 14, is omitted because we will file definitive proxy material pursuant to Regulation 14A not more than 120 days after the close of our most recently ended fiscal year, which proxy material will include the information required by Items 10 through 14 and is incorporated herein by reference.

PART IV

ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES

- (a)(1) Financial Statements. Our consolidated financial statements are incorporated by reference from our 2020 Annual Report.
- (2) Financial Statement Schedules. The schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.
- (3) Exhibits. The following exhibits are submitted with this Annual Report on Form 10-K or, where indicated, incorporated by reference to other filings.

INDEX TO EXHIBITS

- 3.1 [Composite Articles of Incorporation of Watsco, Inc. \(filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the quarter ended June 30, 2012 and incorporated herein by reference\).](#)
- 3.2 [Watsco, Inc. Second Amended and Restated Bylaws effective August 1, 2016 \(filed as Exhibit 3.1 to the Current Report on Form 8-K on August 5, 2016 and incorporated herein by reference\).](#)
- 4.1 Specimen form of Class B Common Stock Certificate (filed as Exhibit 4.6 to the Registration Statement on Form S-1 (No. 33-56646) and incorporated herein by reference). (P)
- 4.2 Specimen form of Common Stock Certificate (filed as Exhibit 4.4 to the Annual Report on Form 10-K for the fiscal year ended December 31, 1994 and incorporated herein by reference). (P)
- 4.3 [Description of Capital Stock \(filed as Exhibit 4.3 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2019 and incorporated herein by reference\).](#)
- 10.1(a) [Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.20 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 1996 and incorporated herein by reference\).](#) *
- 10.1(b) [First Amendment dated January 1, 2001 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.13 to the Annual Report on Form 10-K for the year ended December 31, 2000 and incorporated herein by reference\).](#) *
- 10.1(c) [Second Amendment dated January 1, 2002 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.15 to the Annual Report on Form 10-K for the year ended December 31, 2001 and incorporated herein by reference\).](#) *
- 10.1(d) [Third Amendment dated January 1, 2003 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.11 to the Annual Report on Form 10-K for the year ended December 31, 2002 and incorporated herein by reference\).](#) *
- 10.1(e) [Fourth Amendment dated January 1, 2004 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2004 and incorporated herein by reference\).](#) *
- 10.1(f) [Fifth Amendment dated January 1, 2005 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 and incorporated herein by reference\).](#) *

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- 10.1(g) [Sixth Amendment dated January 1, 2006 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.16 to the Annual Report on Form 10-K for the year ended December 31, 2005 and incorporated herein by reference\).](#) *
- 10.1(h) [Seventh Amendment dated January 1, 2007 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.18 to the Annual Report on Form 10-K for the year ended December 31, 2006 and incorporated herein by reference\).](#) *
- 10.1(i) [Eighth Amendment dated January 1, 2008 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2008 and incorporated herein by reference\).](#) *
- 10.1(j) [Ninth Amendment dated December 10, 2008 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.19 to the Annual Report on Form 10-K for the year ended December 31, 2008 and incorporated herein by reference\).](#) *
- 10.1(k) [Tenth Amendment dated January 1, 2009 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2009 and incorporated herein by reference\).](#) *
- 10.1(l) [Eleventh Amendment dated January 1, 2010 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2010 and incorporated herein by reference\).](#) *
- 10.1(m) [Twelfth Amendment dated January 1, 2011 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2011 and incorporated herein by reference\).](#) *
- 10.1(n) [Thirteenth Amendment dated January 1, 2012 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2012 and incorporated herein by reference\).](#) *
- 10.1(o) [Fourteenth Amendment dated January 1, 2013 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 and incorporated herein by reference\).](#) *
- 10.1(p) [Fifteenth Amendment dated January 1, 2014 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2014 and incorporated herein by reference\).](#) *
- 10.1(q) [Sixteenth Amendment dated January 1, 2015 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2015 and incorporated herein by reference\).](#) *
- 10.1(r) [Seventeenth Amendment dated January 1, 2016 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2016 and incorporated herein by reference\).](#) *
- 10.1(s) [Eighteenth Amendment dated January 1, 2017 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2017 and incorporated herein by reference\).](#) *
- 10.1(t) [Nineteenth Amendment dated January 1, 2018 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2018 and incorporated herein by reference\).](#) *
- 10.1(u) [Twentieth Amendment dated January 1, 2019 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2019 and incorporated herein by reference\).](#) *
- 10.1(v) [Twenty-first Amendment dated January 1, 2020 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad \(filed as Exhibit 10.1 to the Quarterly Report on Form 10-Q for the quarter ended March 31, 2020 and incorporated herein by reference\).](#) *

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10.1(w)	<u>Twenty-second Amendment dated January 1, 2021 to Employment Agreement and Incentive Plan dated January 31, 1996 by and between Watsco, Inc. and Albert H. Nahmad.</u> *#
10.2	<u>Watsco, Inc. 2014 Incentive Compensation Plan (filed as Appendix A to the Definitive Proxy Statement on Schedule 14A in respect of our 2014 Annual Meeting of Shareholders and incorporated herein by reference).</u> *
10.3	<u>Fourth Amended and Restated 1996 Qualified Employee Stock Purchase Plan dated April 18, 2011 (filed as Appendix A to the Definitive Proxy Statement on Schedule 14A in respect of our 2011 Annual Meeting of Shareholders and incorporated herein by reference).</u> *
10.4(a)	<u>Credit Agreement dated as of December 5, 2018, by and among Watsco, Inc., Watsco Canada, Inc. and Carrier Enterprise Mexico, S. de R.L. de C.V., as Borrowers, the Other Lenders From Time to Time Party Thereto, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, JPMorgan Chase Bank, N.A. as Syndication Agent and Branch Banking and Trust Company, U.S. Bank National Association and Wells Fargo Bank, National Association as Co-Documentation Agents (filed as Exhibit 10.1 to the Current Report on Form 8-K on December 11, 2018 and incorporated herein by reference).</u>
10.4(b)	<u>Revolving Credit Increase and Joinder Agreement, dated as of April 10, 2020, by and among Watsco, Inc., Watsco Canada, Inc. and Carrier Enterprise Mexico, S. de R.L. de C.V., as Borrowers, Bank of America, N.A., as Administrative Agent, Swing Line Lender and L/C Issuer, Regions Bank, and PNC Bank N.A. as a joining Lender (filed as Exhibit 10.1 to the Current Report on Form 8-K on April 16, 2020 and incorporated herein by reference).</u>
10.5	<u>Operating Agreement of Carrier Enterprise, LLC (Amended and Restated), dated as of July 1, 2009 (filed as Exhibit 10.2 to the Current Report on Form 8-K on July 8, 2009 and incorporated herein by reference).</u>
10.6	<u>Operating Agreement of Carrier Enterprise Northeast, LLC, dated as of April 30, 2011 (filed as Exhibit 10.29 to the Annual Report on Form 10-K for the year ended December 31, 2011 and incorporated herein by reference).</u>
10.7	<u>Carrier Enterprise Canada (G.P.), Inc. Shareholders' Agreement dated as of April 27, 2012 (filed as Exhibit 10.2 to the Current Report on Form 8-K on May 3, 2012 and incorporated herein by reference).</u>
13	<u>2020 Annual Report to Shareholders (with the exception of the information incorporated by reference into Items 6, 7, 8 and 9 of this Form 10-K, the 2020 Annual Report to Shareholders is provided solely for the information of the SEC and is not deemed "filed" as part of this Form 10-K).</u> #
21.1	<u>Subsidiaries of the Registrant.</u> #
23.1	<u>Consent of Independent Registered Public Accounting Firm – KPMG LLP.</u> #
31.1	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> #
31.2	<u>Certification of Executive Vice President pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> #
31.3	<u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u> #
32.1	<u>Certification of Chief Executive Officer, Executive Vice President and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> +
101.INS	Inline XBRL Instance Document—the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document. #
101.SCH	Inline XBRL Taxonomy Extension Schema Document. #
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document. #
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document. #
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document. #

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101.PRE Inline XBRL Taxonomy Extension Presentation Linkbase Document. #

104 The cover page from the Company's Annual Report on Form 10-K for the year ended December 31, 2020, formatted in Inline XBRL.

filed herewith.

+ furnished herewith.

* Management contract or compensation plan or arrangement.

ITEM 16. FORM 10-K SUMMARY

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

February 26, 2021

By: /s/ Albert H. Nahmad
Albert H. Nahmad, Chief Executive Officer

February 26, 2021

By: /s/ Ana M. Menendez
Ana M. Menendez, Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

<u>SIGNATURE</u>	<u>TITLE</u>	<u>DATE</u>
<u>/s/ ALBERT H. NAHMAD</u> Albert H. Nahmad	Chairman of the Board and Chief Executive Officer (principal executive officer)	February 26, 2021
<u>/s/ ANA M. MENENDEZ</u> Ana M. Menendez	Chief Financial Officer (principal accounting officer and principal financial officer)	February 26, 2021
<u>/s/ CESAR L. ALVAREZ</u> Cesar L. Alvarez	Director	February 26, 2021
<u>/s/ J. MICHAEL CUSTER</u> J. Michael Custer	Director	February 26, 2021
<u>/s/ DENISE DICKINS</u> Denise Dickins	Director	February 26, 2021
<u>/s/ BRIAN E. KEELEY</u> Brian E. Keeley	Director	February 26, 2021
<u>/s/ BOB L. MOSS</u> Bob L. Moss	Director	February 26, 2021
<u>/s/ AARON J. NAHMAD</u> Aaron J. Nahmad	Director and President	February 26, 2021
<u>/s/ STEVEN RUBIN</u> Steven Rubin	Director	February 26, 2021
<u>/s/ GEORGE P. SAPE</u> George P. Sape	Director	February 26, 2021

**TWENTY-SECOND AMENDMENT
TO
EMPLOYMENT AGREEMENT**

This Twenty-second Amendment to Employment Agreement is made and entered into effective as of the 1st day of January 2021, by and between **WATSCO, INC.**, a Florida corporation (hereinafter called the “Company”), and **ALBERT H. NAHMAD** (hereinafter called the “Employee”).

RECITALS

WHEREAS, the Company and the Employee entered into an Employment Agreement effective as of January 31, 1996 (the “Employment Agreement”) pursuant to which the Employee renders certain services to the Company; and

WHEREAS, the Compensation Committee of the Company’s Board of Directors amended the Employment Agreement effective as of January 1, for each of 2001 through 2020; and

WHEREAS, the Compensation Committee of the Company’s Board of Directors has determined that the Employee’s Base Salary will be \$600,000 for calendar year 2021; and

WHEREAS, the Compensation Committee of the Company’s Board of Directors has determined the Employee’s use of the Company’s airplane for personal purposes for up to seventy (70) hours during the calendar year 2021. The Company shall pay all fuel and operational costs incident thereto. The value of the Employee’s usage of the Company’s airplane shall be treated as compensation for tax purposes; and

WHEREAS, the Compensation Committee of the Company’s Board of Directors has set the targets for the long-term performance-based compensation payable in the form of restricted shares by the Company to the Employee for the year 2021; and

WHEREAS, the long-term performance-based compensation payable by the Company to the Employee for the calendar year 2021 shall not exceed \$10 million.

NOW, THEREFORE, in consideration of the mutual promises and covenants set forth in this Twenty-second Amendment, and other good and valuable consideration, the parties to this Twenty-second Amendment agree as follows:

1. All capitalized terms in this Twenty-second Amendment shall have the same meaning as in the Employment Agreement, unless otherwise specified.

2. The Employment Agreement is hereby amended by replacing “Exhibit A-1 — 2020 Performance Goals and Long-term Performance Based Compensation” with the attached “Exhibit A-1 — 2021 Performance Goals and Long-term Performance Based Compensation” thereto.

3. All other terms and conditions of the Employment Agreement shall remain the same.

IN WITNESS WHEREOF, the parties have caused this Twenty-second Amendment to be duly executed effective as of the day and year first above written.

WATSCO, INC.

By: /s/ Barry S. Logan
Barry S. Logan, Executive Vice President

EMPLOYEE

By: /s/ Albert H. Nahmad
Albert H. Nahmad

EXHIBIT A-1
2021 PERFORMANCE GOALS AND LONG-TERM PERFORMANCE BASED COMPENSATION

Overview

Watsco's compensation program is grounded by the guiding principle that compensation should be highly dependent upon long-term shareholder returns. This key tenet of our compensation philosophy has driven the unique design of our program for many years and has enabled our executive leadership team to stay solidly focused on long-term performance. We have generated a compounded annual growth rate for total shareholder return of 19% over the last 30 years.

The most unique aspect of the program is the use of restricted stock that requires an executive to spend his or her entire career with the Company in order to vest. We believe granting restricted stock effectively balances strategic risk-taking and long-term performance, creates an ownership culture, and aligns the interests of high-performing leaders with the interests of our shareholders. Additionally, we believe these awards help build a sustainable future by ensuring that our executives make the right long-term business decisions that will survive well past their retirement.

We began granting restricted stock awards in 1997. All the restricted shares we have granted to our leaders throughout the Company vest upon reaching retirement age (usually 62 or older). Based on data provided by Equilar, the duration of our cliff-vesting period is solely unique to Watsco. Vesting may also occur at an even later date for those who extend their careers beyond age 62. This means that our key leaders will not know the value and cannot realize the value of their equity awards until they have spent their career with the Company. As it relates to our CEO, none of his restricted share awards have ever vested. On a weighted-average basis, his awards will vest in approximately 3.5 years.

In formulating the amount of a potential award, the Compensation Committee believes that the 'present-value' of an award versus the 'face-value' of an award is considerably less due to the unusually long vesting periods and associated risks of forfeiture.

Annual Performance-based Restricted Stock Award

The formula for determining the CEO's Annual Performance-based Restricted Stock Award has been consistent, and for 2021 is as follows:

	Amount of Restricted Stock Award
A. Earnings Per Share (EPS)	
For each \$.01 increase if growth is below 5%	\$ 43,500
For each \$.01 increase if growth is at or above 5%	\$ 65,000
B. Increase in Common Stock Price	
If the closing price of a share of Common Stock on 12/31/21 does not exceed \$226.55	\$ 0
If the closing price of a share of Common Stock on 12/31/21 exceeds \$226.55 but does not equal or exceed \$271.86, for each \$0.01 increase in per share price of a share of Common Stock above \$226.55	\$ 1,200
If the closing price of a share of Common Stock on 12/31/21 equals or exceeds \$271.86, for each \$0.01 increase in per share price of a share of Common Stock above \$226.55	\$ 1,800

Other Considerations

The amount of Performance-Based Restricted Stock Award shall be subject to a cap of \$10 million.

The award shall be paid through the issuance of a number of restricted shares of Class B Common Stock of the Company (the "Shares") equal to the amount determined by dividing (x) the Performance-Based Restricted Stock Award Amount by (y) the closing price for the Class B Common Stock of the Company on the New York Stock Exchange as of the close of trading on December 31, 2021. The value of any fractional shares shall be paid in cash.

The restrictions on the Shares shall lapse on the first to occur of (i) October 15, 2028, (ii) termination of the Executive's employment with the Company by reason of Executive's disability or death, (iii) the Executive's termination of employment with the Company for Good Reason, (iv) the Company's termination of Executive's employment without Cause, or (v) the occurrence of a Change in Control of the Company ("Good Reason," "Cause," and "Change in Control" to be defined in a manner consistent with the most recent grant of Restricted Stock by the Company to the Executive).

The Performance-Based Restricted Stock Award are being made by the Compensation Committee as performance awards of restricted stock pursuant to Section 8 of the Company's 2014 Incentive Compensation Plan or any successor plan (the "Incentive Plan") and are subject to the limitations contained in Section 5(b)(ii) of the Incentive Plan.

Effective as of January 1, 2021

COMPENSATION COMMITTEE

By: /s/ Denise Dickins

Denise Dickins, Chair

ACKNOWLEDGED AND ACCEPTED

By: /s/ Albert H. Nahmad

Albert H. Nahmad

WATSCO, INC. AND SUBSIDIARIES
SELECTED CONSOLIDATED FINANCIAL DATA

The following selected consolidated financial data should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included under Item 8 of Part II, "Financial Statements and Supplementary Data," and the information contained in Item 7 of Part II, "Management's Discussion and Analysis of Financial Condition and Results of Operations" of this Annual Report on Form 10-K for the year ended December 31, 2020.

<i>(In thousands, except per share data)</i>	<u>2020</u>	<u>2019 (1)</u>	<u>2018 (2)</u>	<u>2017</u>	<u>2016</u>
FOR THE YEAR					
Revenues	\$5,054,928	\$4,770,362	\$4,546,653	\$4,341,955	\$4,220,702
Gross profit	1,222,821	1,156,956	1,120,252	1,065,659	1,034,584
Operating income	401,034	366,884	372,082	353,874	345,632
Net income	323,172	295,775	296,529	257,290	235,983
Less: net income attributable to non-controlling interest	53,593	49,825	53,597	49,069	53,173
Net income attributable to Watsco, Inc.	<u>\$ 269,579</u>	<u>\$ 245,950</u>	<u>\$ 242,932</u>	<u>\$ 208,221</u>	<u>\$ 182,810</u>
Diluted earnings per share for Common and Class B common stock	\$ 7.01	\$ 6.50	\$ 6.49	\$ 5.81	\$ 5.15
Cash dividends per share:					
Common stock	\$ 6.925	\$ 6.40	\$ 5.60	\$ 4.60	\$ 3.60
Class B common stock	\$ 6.925	\$ 6.40	\$ 5.60	\$ 4.60	\$ 3.60
Weighted-average Common and Class B common shares outstanding -					
Diluted	35,151	34,676	34,374	32,863	32,617
AT YEAR END					
Total assets	\$2,484,347	\$2,556,161	\$2,161,033	\$2,046,877	\$1,874,649
Total long-term obligations	\$ 144,338	\$ 311,980	\$ 135,752	\$ 22,085	\$ 235,642
Total shareholders' equity	\$1,779,761	\$1,714,767	\$1,601,713	\$1,550,977	\$1,251,748
Number of employees	5,800	5,800	5,200	5,200	5,050

- (1) Effective January 1, 2019, we adopted the provisions of accounting guidance related to leases. Amounts prior to January 1, 2019 have not been adjusted and remain as originally reported for such periods.
- (2) Effective January 1, 2018, we adopted the provisions of accounting guidance related to revenue recognition. Amounts prior to January 1, 2018 have not been adjusted and remain as originally reported for such periods.

**WATSCO, INC. AND SUBSIDIARIES
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Forward-Looking Statements

This Annual Report on Form 10-K 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. Statements which are not historical in nature, including the words "anticipate," "estimate," "could," "should," "may," "plan," "seek," "expect," "believe," "intend," "target," "will," "project," "focused," "outlook," "goal," "designed," and variations of these words and negatives thereof and similar expressions are intended to identify forward-looking statements, including statements regarding, among others, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions and/or joint ventures and investments in unconsolidated entities, (iv) financing plans, and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based on management's current expectations, are not guarantees of future performance and are subject to a number of risks, uncertainties, and changes in circumstances, certain of which are beyond our control. Actual results could differ materially from these forward-looking statements as a result of several factors, including, but not limited to:

- general economic conditions, both in the United States and in the international markets we serve;
- competitive factors within the HVAC/R industry;
- effects of supplier concentration;
- fluctuations in certain commodity costs;
- consumer spending;
- consumer debt levels;
- the continued impact of the COVID-19 pandemic;
- new housing starts and completions;
- capital spending in the commercial construction market;
- access to liquidity needed for operations;
- seasonal nature of product sales;
- weather patterns and conditions;
- insurance coverage risks;
- federal, state, and local regulations impacting our industry and products;
- prevailing interest rates;
- foreign currency exchange rate fluctuations;
- international risk;
- cybersecurity risk; and
- the continued viability of our business strategy.

We believe these forward-looking statements are reasonable; however, you should not place undue reliance on any forward-looking statements, which are based on current expectations. For additional information regarding important factors that may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, please see the discussion included in Item 1A "Risk Factors" of this Annual Report on Form 10-K, as well as the other documents and reports that we file with the SEC. Forward-looking statements speak only as of the date the statements were 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, except as required by applicable law. We qualify any and all of our forward-looking statements by these cautionary factors.

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The following information should be read in conjunction with the information contained in Item 1A, “Risk Factors” and the consolidated financial statements, including the notes thereto, included under Item 8, “Financial Statements and Supplementary Data” of this Annual Report on Form 10-K for the year ended December 31, 2020.

Company Overview

Watsco, Inc. was incorporated in Florida in 1956, and, together with its subsidiaries (collectively, “Watsco,” or “we,” “us,” or “our”) is the largest distributor of air conditioning, heating, and refrigeration equipment, and related parts and supplies (“HVAC/R”) in the HVAC/R distribution industry in North America. At December 31, 2020, we operated from 600 locations in 38 U.S. States, Canada, Mexico, and Puerto Rico with additional market coverage on an export basis to portions 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, a majority of which we operate under non-cancelable operating leases.

Sales of residential central air conditioners, heating equipment, and parts and supplies are seasonal. Furthermore, profitability can be impacted favorably or unfavorably based on weather patterns, particularly during the Summer and Winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the first and fourth quarters. Demand related to the new construction sectors throughout most of the markets we serve tends to be fairly evenly distributed throughout the year and depends largely on housing completions and related weather and economic conditions.

Impact of the COVID-19 Pandemic

A novel strain of coronavirus, COVID-19, surfaced in December 2019 and has spread around the world, including to the United States. In March 2020, the World Health Organization declared COVID-19 a pandemic. For certain periods of the pandemic thus far, some U.S. states had been under executive orders requiring that all workers remain at home unless their work was critical, essential, or life-sustaining. We believe that, based on the various standards published to date, the work our employees perform is essential, and as such we continued to operate with certain modifications during these periods. Certain of our locations experienced short-term closures for COVID-19 employee health concerns or operated at a diminished capacity, which negatively impacted business during March and April of 2020. At the end of the second quarter of 2020, many of the markets in which we operate had begun to ease COVID-19 restrictions that had been in place earlier in the period. However, during the second half of 2020, viral infections began to increase, resulting in the resumption of restrictions in certain markets in which we operate.

Consistent with broader social trends, we have taken steps to safeguard the health of our employees and customers. This includes creating space between work areas, providing ample personal protective equipment and cleaning supplies, having formal policies for mitigation in the event of cases of illness, utilizing technologies where work duties allow to enable work from home capabilities, and instituting contactless sales and servicing capabilities at many of our locations to create social distancing. As of the date of this filing, all our locations are operating, and due to these precautions, have continued to function effectively, including our internal controls over financial reporting. In light of the continued high rate of viral infections that exists as of the date of this filing, there remains significant uncertainty concerning the magnitude of the impact and duration of the COVID-19 pandemic.

In response to the pandemic, we implemented plans intended to preserve adequate liquidity and ensure that our business continued to operate during this uncertain time. In addition, we have taken actions to reduce costs, including reductions in compensation, rent abatement, changes to vendor terms and other austerity measures to curtail discretionary spending in light of the circumstances. Other costs, including hourly wages, overtime, sales commissions, temporary labor, performance-based compensation, advertising, and delivery expenses are expected to vary in correlation with our overall business activity. As restrictions ease and normal economic conditions and operations resume, the various austerity measures to curtail discretionary spending have eased.

With respect to liquidity, we believe that our balance sheet remains strong with \$146.1 million in cash, no outstanding borrowings drawn from our \$560.0 million credit facility and \$1.8 billion of shareholders’ equity as of December 31, 2020. On February 9, 2021, our Board of Directors approved an increase to the quarterly cash dividend per share of Common and Class B common stock to \$1.95 per share beginning with the dividend that will be paid in April 2021. Future dividends and/or changes in dividend rates are at the sole discretion of the Board of Directors and depend upon factors including, but not limited to, cash flow generated by operations, profitability, financial condition, cash requirements, and future prospects. During these uncertain times, we believe that our scale, our current debt-free position, conservative leverage ratio, and our historical ability to generate cash flow positions us well as we work through the impacts of the COVID-19 pandemic.

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The full impact of the COVID-19 pandemic on our financial condition and results of operations will continue to depend on future developments, such as the ultimate duration and scope of the pandemic, its impact on our employees, customers, and suppliers, how quickly normal economic conditions and operations resume and whether the pandemic exacerbates other risks disclosed in Item 1A “Risk Factors” of this Annual Report on Form 10-K for the year ended December 31, 2020. We will continue to actively monitor the situation and may take further actions that alter our business operations as may be required by federal, state or local authorities or that we determine are in the best interests of our employees, customers, suppliers and shareholders.

Joint Ventures with Carrier Global Corporation

On April 3, 2020, United Technologies Corporation completed the spin-off of Carrier Corporation into an independent, publicly traded company, named Carrier Global Corporation (“Carrier”).

In 2009, we formed a joint venture with Carrier, which we refer to as Carrier Enterprise I, in which Carrier contributed 95 of its company-owned locations in 13 Sun Belt states and Puerto Rico, and its export division in Miami, Florida, and we contributed 15 locations that distributed Carrier products. We have an 80% controlling interest in Carrier Enterprise I, and Carrier has a 20% non-controlling interest. The export division, Carrier InterAmerica Corporation, redomesticated from the U.S. Virgin Islands to Delaware effective December 31, 2019, following which Carrier InterAmerica Corporation became a separate operating entity in which we have an 80% controlling interest and Carrier has a 20% non-controlling interest. On August 1, 2019, Carrier Enterprise I acquired substantially all of the HVAC assets and assumed certain of the liabilities of Peirce-Phelps, Inc. (“PPI”), an HVAC distributor operating from 19 locations in Pennsylvania, New Jersey, and Delaware.

In 2011, we formed a second joint venture with Carrier, in which Carrier contributed 28 of its company-owned locations in the Northeast U.S., and we contributed 14 locations in the Northeast U.S., and we then purchased Carrier’s distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have an 80% controlling interest in Carrier Enterprise II, and Carrier has a 20% non-controlling interest. Effective May 31, 2019, we purchased an additional 20% ownership interest in Homans Associates II LLC (“Homans”) from Carrier Enterprise II, following which we owned 100% of Homans. Homans previously operated as a division of Carrier Enterprise II and now operates as one of our stand-alone, wholly owned subsidiaries.

In 2012, we formed a third joint venture with Carrier, which we refer to as Carrier Enterprise III. Carrier contributed 35 of its company-owned locations in Canada to Carrier Enterprise III. We have a 60% controlling interest in Carrier Enterprise III, and Carrier has a 40% non-controlling interest.

Critical Accounting Policies

Management’s discussion and analysis of financial condition and results of operations is based upon the consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these consolidated 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 consolidated 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 significant accounting policies are discussed in Note 1 to our audited consolidated financial statements included with this Annual Report on Form 10-K. Management believes that the following accounting policies include a higher degree of judgment and/or complexity and, thus, are considered critical accounting policies. Management has discussed the development and selection of critical accounting policies with the Audit Committee of the Board of Directors and the Audit Committee has reviewed the disclosures relating to them.

Allowance for Doubtful Accounts

An allowance for doubtful accounts is maintained for estimated losses resulting from the inability of customers to make required payments. We typically do not require our customers to provide collateral. Accounting for doubtful accounts contains uncertainty because management must use judgment to assess the collectability of these accounts. When preparing these estimates, management considers several factors, including the aging of a customer’s account, past transactions with customers, creditworthiness of specific customers, historical trends, and other information, including potential impacts of

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business and economic conditions. Our business and our customers' businesses are seasonal. Sales are lowest during the first and fourth quarters, and past due accounts receivable balances as a percentage of total trade receivables generally increase during these quarters. We review our accounts receivable reserve policy periodically, reflecting current risks, trends, and changes in industry conditions.

The allowance for doubtful accounts was \$7.1 million and \$7.9 million at December 31, 2020 and 2019, respectively, a decrease of \$0.8 million. Accounts receivable balances greater than 90 days past due as a percent of accounts receivable at December 31, 2020 decreased to 1.4% from 1.8% at December 31, 2019. These decreases were primarily attributable to an improvement in the underlying quality of our accounts receivable portfolio at December 31, 2020.

Although we believe the allowance for doubtful accounts is sufficient, a decline in economic conditions could lead to the deterioration in the financial condition of our customers, resulting in an impairment of their ability to make payments and requiring additional allowances that could materially impact our consolidated results of operations. We believe our exposure to customer credit risk is limited due to the large number of customers comprising our customer base and their dispersion across many different geographical regions. Additionally, we mitigate credit risk through credit insurance programs.

Inventory Valuation Reserves

Inventory valuation reserves are established to report inventories at the lower of cost using the weighted-average and the first-in, first-out methods, or net realizable value. As part of the valuation process, inventories are adjusted to reflect excess, slow-moving, and damaged goods. The valuation process contains uncertainty because management must make estimates and use judgment to determine the future salability of inventories. Inventory policies are reviewed periodically, reflecting current risks, trends, and changes in industry conditions. A reserve for estimated inventory shrinkage is also maintained and reflects the results of cycle count programs and physical inventories. When preparing these estimates, management considers historical results, inventory levels, and current operating trends.

Valuation of Goodwill, Indefinite Lived Intangible Assets and Long-Lived Assets

The recoverability of goodwill is evaluated at least annually and when events or changes in circumstances indicate that the carrying amount may not be recoverable. We have one reporting unit that is subject to goodwill impairment testing. In performing the goodwill impairment test, we use a two-step approach. The first step compares the reporting unit's fair value to its carrying value. If the carrying value exceeds the fair value, a second step is performed to measure the amount of impairment loss, if any. The identification and measurement of goodwill impairment involves the estimation of the fair value of our reporting unit and contains uncertainty because management must use judgment in determining appropriate assumptions to be used in the measurement of fair value. On January 1, 2021, we performed our annual evaluation of goodwill impairment and determined that the estimated fair value of our reporting unit significantly exceeded its carrying value.

The recoverability of indefinite lived intangibles and long-lived assets are also evaluated on an annual basis or more often if deemed necessary. Indefinite lived intangibles and long-lived assets not subject to amortization are assessed for impairment by comparing the fair value of the intangible asset or long-lived asset to its carrying amount to determine if a write-down to fair value is required. Our annual evaluation did not indicate any impairment of indefinite lived intangibles or long-lived assets.

The estimates of fair value of our reporting unit, indefinite lived intangibles, and long-lived assets are based on the best information available as of the date of the assessment and incorporates management's assumptions about expected future cash flows and contemplates other valuation techniques. Future cash flows can be affected by changes in the industry, a declining economic environment, or market conditions. There have been no events or circumstances from the date of our assessments that would have had an impact on this conclusion. The carrying amounts of goodwill, intangibles, and long-lived assets were \$999.9 million and \$1,009.4 million at December 31, 2020 and 2019, respectively, a decrease of \$9.5 million. Although no impairment losses have been recorded to date, there can be no assurance that impairments will not occur in the future. An adjustment to the carrying value of goodwill, intangibles, and long-lived assets could materially adversely impact the consolidated results of operations.

Loss Contingencies

Accruals are recorded for various contingencies including self-insurance, legal proceedings, environmental matters, and other claims that arise in the normal course of business. The estimation process contains uncertainty because accruals are based on judgment, the probability of losses and, where applicable, the consideration of opinions of external legal counsel and actuarially determined estimates. Additionally, we record receivables from third party insurers when recovery has been determined to be probable.

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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 several 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 self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occur and exceed these estimates, additional reserves may be required and could materially impact the consolidated results of operations. 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 \$5.4 million and \$3.1 million at December 31, 2020 and 2019, respectively, were established related to such insurance programs.

Income Taxes

Income taxes are accounted for under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial reporting basis and the tax basis of assets and liabilities at enacted tax rates expected to be in effect when such amounts are recovered or settled. The use of estimates by management is required to determine income tax expense, deferred tax assets, and any related valuation allowance and deferred tax liabilities. A valuation allowance of \$0.7 million was recorded at both December 31, 2020 and 2019 due to uncertainties related to the ability to utilize a portion of the deferred tax assets primarily arising from foreign net operating loss carryforwards. The valuation allowance is based on estimates of future taxable income by jurisdiction in which the deferred tax assets will be recoverable. These estimates can be affected by several factors, including changes to tax laws, or possible tax audits, or general economic conditions, or competitive pressures that could affect future taxable income. Although management believes that the estimates are reasonable, the deferred tax asset and any related valuation allowance will need to be adjusted if management's estimates of future taxable income differ from actual taxable income. An adjustment to the deferred tax asset and any related valuation allowance could materially impact the consolidated results of operations.

New Accounting Standards

Refer to Note 1 to our audited consolidated financial statements included in this Annual Report on Form 10-K for a discussion of recently adopted accounting standards.

Results of Operations

The following table summarizes information derived from our audited consolidated statements of income, expressed as a percentage of revenues, for the years ended December 31, 2020, 2019 and 2018.

	2020	2019	2018
Revenues	100.0%	100.0%	100.0%
Cost of sales	75.8	75.7	75.4
Gross profit	24.2	24.3	24.6
Selling, general and administrative expenses	16.5	16.8	16.7
Other income	0.2	0.2	0.2
Operating income	7.9	7.7	8.2
Interest expense, net	0.0	0.1	0.1
Income before income taxes	7.9	7.6	8.1
Income taxes	1.5	1.4	1.6
Net income	6.4	6.2	6.5
Less: net income attributable to non-controlling interest	1.1	1.0	1.2
Net income attributable to Watsco, Inc.	5.3%	5.2%	5.3%

Note: Due to rounding, percentages may not add up to 100.

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The following narratives reflect our acquisition of the HVAC distribution businesses of N&S Supply of Fishkill, Inc. (“N&S”) in November 2019, PPI in August 2019, Dunphey & Associates Supply Co., Inc. (“DASCO”) in April 2019, as well as the purchase of an additional 1.8% ownership interest in Russell Sigler, Inc. (“RSI”) in April 2019, and the purchase of an additional 20% ownership interest in Homans effective May 31, 2019. We did not acquire any businesses during 2020.

In the following narratives, computations and other information referring to “same-store basis” exclude the effects of locations closed, acquired, or locations opened, in each case during the immediately preceding 12 months, unless such locations are within close geographical proximity to existing locations. At December 31, 2020 and 2019, two and nine locations, respectively, that we opened were near existing locations and were therefore included in “same-store basis” information.

The table below summarizes the changes in our locations for 2020 and 2019:

	<u>Number of Locations</u>
December 31, 2018	571
Opened	14
Acquired	33
Closed	(12)
December 31, 2019	606
Opened	3
Closed	(9)
December 31, 2020	<u>600</u>

2020 Compared to 2019

Revenues

Revenues for 2020 increased \$284.6 million, or 6%, to \$5,054.9 million, including \$174.1 million attributable to new locations acquired and \$4.2 million from other locations opened during the preceding 12 months, offset by \$10.9 million from locations closed. Sales of HVAC equipment (69% of sales) increased 7%, sales of other HVAC products (28% of sales) increased 3% and sales of commercial refrigeration products (3% of sales) decreased 4%. On a same-store basis, revenues increased \$117.2 million, or 2%, as compared to 2019, reflecting a 4% increase in sales of HVAC equipment (69% of sales), which included a 9% increase in residential HVAC equipment (10% increase in U.S. markets and a 2% decrease in international markets) and a 15% decrease in sales of commercial HVAC equipment (10% decrease in U.S. markets and a 27% decrease in international markets), flat sales of other HVAC products (28% of sales), and a 4% decrease in sales of commercial refrigeration products (3% of sales). The increase in same-store revenues of HVAC equipment was primarily due to demand for the replacement of residential HVAC equipment, partially offset by lower sales of commercial HVAC equipment due to the pandemic-related market disruption. The increase in residential HVAC equipment was composed of a 10% increase in volume while the average selling price remained flat.

Gross Profit

Gross profit for 2020 increased \$65.9 million, or 6%, to \$1,222.8 million, primarily as a result of increased revenues. Gross profit margin declined 10 basis-points to 24.2% in 2020 versus 24.3% in 2019, primarily due to a shift in sales mix toward HVAC equipment, which generates a lower gross profit margin than non-equipment products.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for 2020 increased \$32.7 million, or 4%, to \$833.1 million, primarily due to increased revenues. Selling, general and administrative expenses as a percentage of revenues for 2020 decreased to 16.5% versus 16.8% in 2019. On a same-store basis, selling, general and administrative expenses decreased 1% as compared to 2019 primarily due to actions taken to improve operating efficiencies and to reduce costs and curtail discretionary spending in response to the pandemic. Selling, general and administrative expenses included \$3.0 million of additional costs for 2020 in excess of 2019 for ongoing technology initiatives, including initiatives designed to mitigate the impact of the pandemic.

Other Income

Other income of \$11.3 million and \$10.3 million for the years ended December 31, 2020 and 2019, respectively, represented our share of the net income of RSI.

Operating Income

Operating income for 2020 increased \$34.2 million, or 9%, to \$401.0 million. Operating margin improved 20 basis-points to 7.9% in 2020 from 7.7% at 2019. On a same-store basis, operating margin was 8.1% in 2020 as compared to 7.7% in 2019.

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Interest Expense, Net

Interest expense, net for 2020 decreased \$2.8 million, or 69%, to \$1.2 million, primarily as a result of a decrease in average outstanding borrowings and a lower effective interest rate for the 2020 period, as compared to the same period in 2019.

Income Taxes

Income taxes increased 14% to \$76.6 million and represent a composite of the income taxes attributable to our wholly owned operations and income taxes attributable to the Carrier joint ventures, which are primarily taxed as partnerships for income tax purposes; therefore, Carrier is responsible for its proportionate share of income taxes attributable to its share of earnings from these joint ventures. The effective income tax rates attributable to us were 22.0% and 21.2% for 2020 and 2019, respectively. The increase was primarily due to higher state income taxes, offset by greater share-based compensation and lower estimated foreign withholding taxes in 2019 as compared to 2020.

Net Income Attributable to Watsco, Inc.

Net income attributable to Watsco in 2020 increased \$23.6 million, or 10%, to \$269.6 million. The increase was primarily driven by higher revenues and gross profit, and lower interest expense, net.

Refer to “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in our Annual Report on Form 10-K for the year ended December 31, 2019 for a discussion of results of operations for the year ended December 31, 2019 compared to the year ended December 31, 2018.

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 for HVAC/R products, which peaks in the months of May through August. Significant factors that could affect our liquidity include the following:

- cash needed to fund our business (primarily working capital requirements);
- borrowing capacity under our revolving credit facility;
- the ability to attract long-term capital with satisfactory terms;
- acquisitions, including joint ventures and investments in unconsolidated entities;
- dividend payments;
- capital expenditures; and
- the timing and extent of common stock repurchases.

Sources and Uses of Cash

We rely on cash flows from operations and borrowing capacity under our revolving credit agreement to fund seasonal working capital needs and for other general corporate purposes, including dividend payments (if and as declared by our Board of Directors), capital expenditures, business acquisitions, and development of our long-term operating and technology strategies. Additionally, we may also generate cash through the issuance and sale of our Common stock.

As of December 31, 2020, we had \$146.1 million of cash and cash equivalents, of which \$82.8 million was held by foreign subsidiaries. The repatriation of cash balances from our foreign subsidiaries could have adverse tax impacts or be subject to capital controls; however, these balances are generally available to fund the ordinary business operations of our foreign subsidiaries without legal restrictions.

We believe that our operating cash flows, cash on hand, and funds available for borrowing under our revolving credit agreement are sufficient to meet our liquidity needs in the foreseeable future. However, there can be no assurance that our current sources of available funds will be sufficient to meet our cash requirements.

Our access to funds under our revolving credit agreement depends on the ability of the syndicate banks to meet their respective funding commitments. Disruptions in the credit and capital markets could adversely affect our ability to draw on our revolving credit agreement and may also adversely affect the determination of interest rates, particularly rates based on LIBOR, which is one of the base rates under our revolving credit agreement. LIBOR is the subject of recent proposals for reform that currently provide for the phase-out of LIBOR after December 31, 2021. The consequences of these developments with respect to LIBOR cannot be entirely predicted but could result in an increase in the cost of our debt, as it is currently anticipated that lenders will replace LIBOR with the Secured Overnight Financing Rate (“SOFR”), which may exceed what would have been the comparable LIBOR rate. Additionally, disruptions in the credit and capital markets could also result in increased borrowing costs and/or reduced borrowing capacity under our revolving credit agreement.

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Working Capital

Working capital decreased to \$997.3 million at December 31, 2020 from \$1,085.0 million at December 31, 2019, primarily as a result of lower levels of inventory due to inventory optimization activities, pandemic-related supply chain disruptions, and higher levels of accounts payable and accrued expenses in 2020 versus 2019.

Cash Flows

The following table summarizes our cash flow activity for 2020 and 2019 (in millions):

	<u>2020</u>	<u>2019</u>	<u>Change</u>
Cash flows provided by operating activities	\$ 534.4	\$ 335.8	\$ 198.6
Cash flows used in investing activities	\$ (16.3)	\$ (81.0)	\$ 64.7
Cash flows used in financing activities	\$ (448.5)	\$ (264.0)	\$ (184.5)

The individual items contributing to cash flow changes for the years presented are detailed in the audited consolidated statements of cash flows contained in this Annual Report on Form 10-K.

Operating Activities

The increase in net cash provided by operating activities was primarily due to a reduction in the level of inventories and the comparative timing of payments for accrued expenses and other current liabilities in 2020 versus 2019.

Investing Activities

Net cash used in investing activities was lower in 2020 due to cash consideration paid for acquisitions and the purchase of an additional ownership interest in RSI in 2019, whereas we acquired no new businesses or any portions thereof in 2020.

Financing Activities

The increase in net cash used in financing activities was primarily attributable to net repayments under our revolving credit agreement and an increase in dividends paid in 2020.

Revolving Credit Agreement

We maintain an unsecured, syndicated multicurrency revolving credit agreement, which we use to fund seasonal working capital needs and for other general corporate purposes, including acquisitions, dividends (if and as declared by our Board of Directors), capital expenditures, stock repurchases and issuances of letters of credit. On April 10, 2020, we increased the aggregate borrowing capacity of our revolving credit agreement from \$500.0 million to \$560.0 million. The credit facility has a seasonal component from October 1 to March 31, during which the borrowing capacity may be reduced to \$460.0 million at our discretion, and we effected this reduction in 2020. Included in the credit facility are a \$100.0 million swingline subfacility, a \$10.0 million letter of credit subfacility, a \$75.0 million alternative currency borrowing sublimit and an \$8.0 million Mexican borrowing sublimit. The credit agreement matures on December 5, 2023.

Borrowings under the credit facility bear interest at either LIBOR-based rates plus a spread, which ranges from 87.5 to 150.0 basis-points (LIBOR plus 87.5 basis-points at December 31, 2020), depending on our ratio of total debt to EBITDA, or on rates based on the highest of the Federal Funds Effective Rate plus 0.5%, the Prime Rate or the Eurocurrency Rate plus 1.0%, in each case plus a spread which ranges from 0 to 50.0 basis-points (0 basis-points at December 31, 2020), depending on our ratio of total debt to EBITDA. We pay a variable commitment fee on the unused portion of the commitment under the revolving credit agreement, ranging from 7.5 to 20.0 basis-points (7.5 basis-points at December 31, 2020).

At December 31, 2020 there was no outstanding balance under the revolving credit agreement. At December 31, 2019 \$155.7 million was outstanding under the revolving credit agreement. The revolving credit agreement contains customary affirmative and negative covenants, including financial covenants with respect to consolidated leverage and interest coverage ratios, and other customary restrictions. We believe we were in compliance with all covenants at December 31, 2020.

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Contractual Obligations

The following table summarizes our significant contractual obligations at December 31, 2020.

<u>Contractual Obligations</u>	<u>Payments due by Period (in millions)</u>						<u>Total</u>
	<u>2021</u>	<u>2022</u>	<u>2023</u>	<u>2024</u>	<u>2025</u>	<u>Thereafter</u>	
Operating leases (1)	\$ 77.2	\$62.3	\$44.9	\$25.1	\$ 9.7	\$ 6.8	\$226.0
Purchase obligations (2)	31.8	—	—	—	—	—	31.8
Total	\$109.0	\$62.3	\$44.9	\$25.1	\$ 9.7	\$ 6.8	\$257.8

- (1) Includes imputed interest of \$16.2 million. Additional information related to operating leases can be found in Note 2 to our audited consolidated financial statements contained in this Annual Report on Form 10-K.
- (2) Purchase obligations include amounts committed under purchase orders for goods with defined terms as to price, quantity, and delivery. Purchase orders made in the ordinary course of business that are cancelable are excluded from the above table. Any amounts for which we are liable under purchase orders for goods received are reflected in Accounts Payable in our audited consolidated balance sheets and are excluded from the above table.

We have not included in the contractual obligations table above approximately \$5.5 million of net liabilities for unrecognized tax benefits relating to various tax positions we have taken, the timing of which is uncertain.

At December 31, 2020, there were no commercial obligations outstanding under our revolving credit agreement.

Off-Balance Sheet Arrangements

Refer to Note 16 to our audited consolidated financial statements contained in this Annual Report on Form 10-K, under the caption “Off-Balance Sheet Financial Instruments,” for a discussion of a standby letter of credit and performance bonds for which we were contingently liable at December 31, 2020. Such discussion is incorporated herein by reference.

Purchase of Remaining Ownership Interest in Joint Venture

Effective May 31, 2019, we purchased an additional 20% ownership interest in Homans from Carrier Enterprise II for cash consideration of \$32.4 million, which increased our ownership in Homans to 100%. Homans previously operated as a division of Carrier Enterprise II and subsequent to the purchase operates as a wholly owned subsidiary of the Company with 17 locations in the Northeastern U.S.

Investment in Unconsolidated Entity

On June 21, 2017, Carrier Enterprise I acquired a 34.9% ownership interest in RSI, an HVAC distributor operating from 30 locations in the Western U.S. for cash consideration of \$63.6 million, of which we contributed \$50.9 million, and Carrier contributed \$12.7 million. Effective June 29, 2018, Carrier Enterprise I acquired an additional 1.4% ownership interest in RSI, which increased Carrier Enterprise I’s ownership interest in RSI to 36.3% for cash consideration of \$3.8 million, of which we contributed \$3.0 million and Carrier contributed \$0.8 million. Effective April 22, 2019, Carrier Enterprise I acquired an additional 1.8% ownership interest in RSI, which increased Carrier Enterprise I’s ownership interest in RSI to 38.1% for cash consideration of \$4.9 million, of which we contributed \$3.9 million and Carrier contributed \$1.0 million.

Carrier Enterprise I is a party to a shareholders’ agreement (the “Shareholders’ Agreement”) with RSI and its shareholders. Pursuant to the Shareholders’ Agreement, RSI’s shareholders have the right to sell, and Carrier Enterprise I has the obligation to purchase, their respective shares of RSI for a purchase price determined based on either book value or a multiple of EBIT, the latter of which Carrier Enterprise I used to calculate the price paid for its investment in RSI. RSI’s shareholders may transfer their respective shares of RSI common stock only to members of the Sigler family or to Carrier Enterprise I, and, at any time from and after the date on which Carrier Enterprise I owns 85% or more of RSI’s outstanding common stock, it has the right, but not the obligation, to purchase from RSI’s shareholders the remaining outstanding shares of RSI common stock. At December 31, 2020, the estimated purchase amount we would be contingently liable for was approximately \$200.0 million. We believe that our operating cash flows, cash on hand, and funds available for borrowing under our revolving credit agreement will be sufficient to purchase any additional ownership interests in RSI.

Acquisitions

On November 26, 2019, one of our wholly owned subsidiaries acquired certain assets and assumed certain liabilities of N&S, a distributor of air conditioning, heating and plumbing products operating from seven locations in New York and Connecticut. The purchase price was composed of cash consideration of \$12.0 million, the issuance of 22,435 shares of Common stock having a fair value of \$3.9 million, net of a discount for lack of marketability, and the repayment of certain indebtedness.

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On August 1, 2019, Carrier Enterprise I acquired substantially all the HVAC assets and assumed certain of the liabilities of PPI, an HVAC distributor operating from 19 locations in Pennsylvania, New Jersey, and Delaware, for \$85.0 million less certain average revolving indebtedness. Consideration for the net purchase price consisted of \$10.0 million in cash, 372,543 shares of Common stock having a fair value of \$58.3 million, net of a discount for lack of marketability, and the repayment of certain average revolving indebtedness. Carrier contributed cash of \$17.0 million to Carrier Enterprise I in connection with the acquisition of PPI.

On April 2, 2019, one of our wholly owned subsidiaries acquired certain assets and assumed certain liabilities of DASCO, a distributor of air conditioning and heating products operating from seven locations in New Jersey, New York and Connecticut. The purchase price was composed of cash consideration of \$16.8 million and the issuance of 50,952 shares of Common stock having a fair value of \$6.9 million, net of a discount for lack of marketability.

We continually evaluate potential acquisitions and/or joint ventures and investments in unconsolidated entities. We routinely hold discussions with several acquisition candidates. Should suitable acquisition opportunities arise that would require additional financing, we believe our financial position and earnings history provide a sufficient basis for us to either obtain additional debt financing at competitive rates and on reasonable terms or raise capital through the issuance of equity securities.

Common Stock Dividends

We paid cash dividends of \$6.925, \$6.40 and \$5.60 per share of Common stock and Class B common stock in 2020, 2019, and 2018, respectively. On January 4, 2021, our Board of Directors declared a regular quarterly cash dividend of \$1.775 per share of both Common and Class B common stock that was paid on January 29, 2021 to shareholders of record as of January 15, 2021. On February 9, 2021, our Board of Directors approved an increase to the quarterly cash dividend per share of Common and Class B common stock to \$1.95 per share from \$1.775 per share, beginning with the dividend that will be paid in April 2021. Future dividends and/or changes in dividend rates are at the sole discretion of the Board of Directors and depend upon factors including, but not limited to, cash flow generated by operations, profitability, financial condition, cash requirements, and future prospects.

Company Share Repurchase Program

In September 1999, our Board of Directors authorized the repurchase, at management's discretion, of up to 7,500,000 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. We last repurchased shares under this plan in 2008. In aggregate, 6,370,913 shares of Common and Class B common stock have been repurchased at a cost of \$114.4 million since the inception of the program. At December 31, 2020, there were 1,129,087 shares remaining authorized for repurchase under the program.

Quantitative and Qualitative Disclosures About Market Risk

We are exposed to market risks, including fluctuations in foreign currency exchange rates and interest rates. To manage certain of these exposures, we use derivative instruments, including forward and option contracts and swaps. We use derivative instruments as risk management tools and not for trading purposes.

Foreign Currency Exposure

We are exposed to cash flow and earnings fluctuations resulting from currency exchange rate variations. These exposures are transactional and translational in nature. The foreign currency exchange rates to which we are exposed are the Canadian dollar and Mexican peso. Revenues in these markets accounted for 6% and 2%, respectively, of our total revenues for 2020.

Our transactional exposure primarily relates to purchases by our Canadian operations in currencies other than their local currency. To mitigate the impact of currency exchange rate movements on these purchases, we use foreign currency forward contracts. By entering into these foreign currency forward contracts, we lock in exchange rates that would otherwise cause losses should the U.S. dollar strengthen and gains should the U.S. dollar weaken, in each case against the Canadian dollar. We had only one foreign exchange contract at December 31, 2020, the total notional value of which was \$1.0 million, and such contract expired during January 2021. For the year ended December 31, 2020, foreign currency transaction gains and losses did not have a material impact on our results of operations.

We have exposure related to the translation of financial statements of our Canadian operations into U.S. dollars, our functional currency. We do not currently hold any derivative contracts that hedge our foreign currency translational exposure. A 10% change in the Canadian dollar would have had an estimated \$2.5 million impact to net income for the year ended December 31, 2020.

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Historically, fluctuations in these exchange rates have not materially impacted our results of operations. Our exposure to currency rate fluctuations could be material in the future if these fluctuations become significant or if our Canadian and Mexican markets grow and represent a larger percentage of our total revenues.

See Note 17 to our audited consolidated financial statements included in this Annual Report on Form 10-K for further information on our derivative instruments.

Interest Rate Exposure

Our revolving credit facility exposes us to interest rate risk because borrowings thereunder accrue interest at one or more variable interest rates. Our interest rate risk management objectives are to limit the impact of interest rate changes on earnings and cash flows and to lower overall borrowing costs. To achieve these objectives, we have historically entered into interest rate swap agreements with financial institutions that have investment grade credit ratings, thereby minimizing credit risk associated with these instruments. We do not currently hold any such swap agreements or any other derivative contracts that hedge our interest rate exposure, but we may enter into such instruments in the future.

At December 31, 2020, we had no exposure to interest rates based on variable debt outstanding as no amount was outstanding under our revolving credit agreement, however, we evaluated our exposure to interest rates based on the average amount of variable debt outstanding under our revolving credit agreement during 2020 and determined that a 100 basis-point change in interest rates would result in an impact to income before taxes of approximately \$0.7 million. See Note 8 to our audited consolidated financial statements included in this Annual Report on Form 10-K for further information about our debt.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f). Our internal control system was designed to provide reasonable assurance to our management and Board of Directors regarding the reliability of financial reporting and the preparation and fair presentation of our published consolidated financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective may not prevent or detect misstatements and can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of our management, including our Chief Executive Officer, Executive Vice President and Chief Financial Officer, we conducted an assessment of the effectiveness of our internal control over financial reporting as of December 31, 2020. The assessment was based on criteria established in the framework *Internal Control — Integrated Framework (2013)*, issued by the Committee of Sponsoring Organizations (“COSO”) of the Treadway Commission. Based on this assessment under the COSO framework, our management concluded that our internal control over financial reporting was effective as of December 31, 2020. The effectiveness of our internal control over financial reporting as of December 31, 2020 has been audited by KPMG LLP, an independent registered public accounting firm, as stated in their report that is included herein.

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors
Watsco, Inc.:

Opinion on Internal Control Over Financial Reporting

We have audited Watsco, Inc. and subsidiaries (the Company) internal control over financial reporting as of December 31, 2020, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2020, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2020, and the related notes (collectively, the consolidated financial statements), and our report dated February 26, 2021 expressed an unqualified opinion on those consolidated financial statements.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control Over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ KPMG LLP

Miami, Florida
February 26, 2021

Report of Independent Registered Public Accounting Firm

To the Shareholders and Board of Directors
Watsco, Inc.:

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Watsco, Inc. and subsidiaries (the Company) as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2020, and the related notes (collectively, the consolidated financial statements). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2020, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2020, based on criteria established in Internal Control – Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 26, 2021 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

Change in Accounting Principle

As discussed in Note 2 to the consolidated financial statements, the Company has changed its method of accounting for leases as of January 1, 2019 due to the adoption of Accounting Standards Update No. 2016-02, Leases (Topic 842), as amended.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matter

The critical audit matter communicated below is a matter arising from the current period audit of the consolidated financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the consolidated financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of a critical audit matter does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Evaluation of inventory net realizable value adjustments related to excess and slow-moving inventory

As discussed in Note 1 to the consolidated financial statements, the Company values its inventory at the lower of cost using weighted-average cost basis and first-in, first-out methods, or net realizable value. The Company adjusts excess, slow-moving, and damaged inventory to their estimated net realizable value. As of December 31, 2020, the Company's inventory balance was \$781,299 thousand.

We identified the evaluation of inventory net realizable value adjustments related to excess and slow-moving inventory as a critical audit matter due to the amount of judgment required by the Company in making such estimates. As a result, there was a high degree of subjective auditor judgment in assessing such estimates, specifically as it related to the future salability of inventories.

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The following are the primary procedures we performed to address this critical audit matter. We evaluated the design and tested the operating effectiveness of certain internal controls over the Company's process to estimate net realizable values related to excess and slow-moving inventory. This included controls related to the future salability of inventories, assumptions used for excess and slow-moving inventory, and the Company's review of inventory net realizable value adjustments. We compared a selection of inventory units to historical performance to assess possible write-down indications and future salability. We performed a sensitivity analysis under various scenarios and analyzed trends of total adjustments to net realizable values in relation to total inventory to test the Company's determination of the inventory valuation and adjustments related to excess and slow-moving inventory.

/s/ KPMG LLP

We have served as the Company's auditor since 2009.

Miami, Florida
February 26, 2021

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME

<i>(In thousands, except per share data)</i>	Years Ended December 31,		
	2020	2019	2018
Revenues	\$ 5,054,928	\$ 4,770,362	\$ 4,546,653
Cost of sales	3,832,107	3,613,406	3,426,401
Gross profit	1,222,821	1,156,956	1,120,252
Selling, general and administrative expenses	833,051	800,328	757,452
Other income	11,264	10,256	9,282
Operating income	401,034	366,884	372,082
Interest expense, net	1,239	4,032	2,740
Income before income taxes	399,795	362,852	369,342
Income taxes	76,623	67,077	72,813
Net income	323,172	295,775	296,529
Less: net income attributable to non-controlling interest	53,593	49,825	53,597
Net income attributable to Watsco, Inc.	\$ 269,579	\$ 245,950	\$ 242,932
Earnings per share for Common and Class B common stock:			
Basic	\$ 7.03	\$ 6.51	\$ 6.50
Diluted	\$ 7.01	\$ 6.50	\$ 6.49

See accompanying notes to consolidated financial statements.

WATSCO, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

<i>(In thousands)</i>	Years Ended December 31,		
	2020	2019	2018
Net income	\$323,172	\$295,775	\$296,529
Other comprehensive income (loss), net of tax			
Foreign currency translation adjustment	6,272	12,298	(20,493)
Unrealized gain (loss) on cash flow hedging instruments	880	(1,461)	1,918
Reclassification of gain on cash flow hedging instruments into earnings	(418)	(352)	(157)
Other comprehensive income (loss)	6,734	10,485	(18,732)
Comprehensive income	329,906	306,260	277,797
Less: comprehensive income attributable to non-controlling interest	56,144	53,392	46,913
Comprehensive income attributable to Watsco, Inc.	<u>\$273,762</u>	<u>\$252,868</u>	<u>\$230,884</u>

See accompanying notes to consolidated financial statements.

**WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS**

<i>(In thousands, except share and per share data)</i>	December 31,	
	2020	2019
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 146,067	\$ 74,454
Accounts receivable, net	535,288	533,810
Inventories, net	781,299	920,786
Other current assets	21,791	17,680
Total current assets	1,484,445	1,546,730
Property and equipment, net	98,225	98,523
Operating lease right-of-use assets	209,169	223,369
Goodwill	412,486	411,217
Intangible assets, net	169,929	172,004
Investment in unconsolidated entity	97,847	94,833
Other assets	12,246	9,485
	\$2,484,347	\$2,556,161
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities:		
Current portion of long-term obligations	\$ 71,804	\$ 69,421
Accounts payable	251,553	239,666
Accrued expenses and other current liabilities	163,788	152,630
Total current liabilities	487,145	461,717
Long-term obligations:		
Borrowings under revolving credit agreement	—	155,700
Operating lease liabilities, net of current portion	139,527	154,271
Finance lease liabilities, net of current portion	4,811	2,009
Total long-term obligations	144,338	311,980
Deferred income taxes and other liabilities	73,103	67,697
Commitments and contingencies		
Watsco, Inc. shareholders' equity:		
Common stock, \$0.50 par value, 60,000,000 shares authorized; 37,702,489 and 37,536,363 shares outstanding at December 31, 2020 and 2019, respectively	18,851	18,768
Class B common stock, \$0.50 par value, 10,000,000 shares authorized; 5,691,456 and 5,529,944 shares outstanding at December 31, 2020 and 2019, respectively	2,846	2,765
Preferred stock, \$0.50 par value, 10,000,000 shares authorized; no shares issued	—	—
Paid-in capital	950,915	907,877
Accumulated other comprehensive loss, net of tax	(34,867)	(39,050)
Retained earnings	636,373	632,507
Treasury stock, at cost, 4,823,988 shares of Common stock and 48,263 shares of Class B common stock at both December 31, 2020 and 2019, respectively	(87,440)	(87,440)
Total Watsco, Inc. shareholders' equity	1,486,678	1,435,427
Non-controlling interest	293,083	279,340
Total shareholders' equity	1,779,761	1,714,767
	\$2,484,347	\$2,556,161

See accompanying notes to consolidated financial statements.

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

<i>(In thousands, except share and per share data)</i>	Common Stock, Class B Common Stock and Preferred Stock Shares	Common Stock, Class B Common Stock and Preferred Stock Amount	Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Non- controlling Interest	Total
Balance at December 31, 2017	37,228,715	\$ 21,050	\$804,008	\$ (34,221)	\$594,556	\$(87,440)	\$253,024	\$1,550,977
Cumulative-effect adjustment				301	(301)			—
Net income					242,932		53,597	296,529
Other comprehensive loss				(12,048)			(6,684)	(18,732)
Issuances of non-vested restricted shares of common stock	142,865	71	(71)					—
Forfeitures of non-vested restricted shares of common stock	(10,000)	(5)	5					—
Common stock contribution to 401(k) plan	17,318	9	2,936					2,945
Stock issuances from exercise of stock options and employee stock purchase plan	64,423	32	7,820					7,852
Retirement of common stock	(28,781)	(14)	(5,030)					(5,044)
Share-based compensation			15,631					15,631
Cash dividends declared and paid on Common and Class B common stock, \$5.60 per share					(209,218)			(209,218)
Common stock issued for Alert Labs, Inc.	47,103	24	6,822					6,846
Investment in unconsolidated entity							752	752
Distributions to non-controlling interest							(46,825)	(46,825)
Balance at December 31, 2018	<u>37,461,643</u>	<u>21,167</u>	<u>832,121</u>	<u>(45,968)</u>	<u>627,969</u>	<u>(87,440)</u>	<u>253,864</u>	<u>1,601,713</u>

Continued on next page.

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<i>(In thousands, except share and per share data)</i>	Common Stock, Class B Common Stock and Preferred Stock Shares	Common Stock, Class B Common Stock and Preferred Stock Amount	Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Non- controlling Interest	Total
Balance at December 31, 2018	37,461,643	21,167	832,121	(45,968)	627,969	(87,440)	253,864	1,601,713
Net income					245,950		49,825	295,775
Other comprehensive gain				6,918			3,567	10,485
Issuances of non-vested restricted shares of common stock	173,940	87	(87)					—
Forfeitures of non-vested restricted shares of common stock	(12,837)	(7)	7					—
Common stock contribution to 401(k) plan	30,715	15	4,259					4,274
Stock issuances from exercise of stock options and employee stock purchase plan	105,288	53	13,411					13,464
Retirement of common stock	(10,623)	(5)	(1,647)					(1,652)
Share-based compensation			16,537					16,537
Cash dividends declared and paid on Common and Class B common stock, \$6.40 per share					(241,412)			(241,412)
Common stock issued for Dunphey & Associates Supply Co., Inc.	50,952	25	6,866					6,891
Investment in unconsolidated entity							988	988
Decrease in non-controlling interest in Carrier Enterprise II				(25,768)			(6,632)	(32,400)
Common stock issued for Peirce-Phelps, Inc.	372,543	186	58,158					58,344
Investment in Peirce-Phelps, Inc.							17,000	17,000
Common stock issued for N&S Supply of Fishkill, Inc.	22,435	12	4,020					4,032
Distributions to non-controlling interest							(39,272)	(39,272)
Balance at December 31, 2019	<u>38,194,056</u>	<u>21,533</u>	<u>907,877</u>	<u>(39,050)</u>	<u>632,507</u>	<u>(87,440)</u>	<u>279,340</u>	<u>1,714,767</u>

Continued on next page.

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<i>(In thousands, except share and per share data)</i>	Common Stock, Class B Common Stock and Preferred Stock Shares	Common Stock, Class B Common Stock and Preferred Stock Amount	Paid-In Capital	Accumulated Other Comprehensive Loss	Retained Earnings	Treasury Stock	Non- controlling Interest	Total
Balance at December 31, 2019	38,194,056	21,533	907,877	(39,050)	632,507	(87,440)	279,340	1,714,767
Net income					269,579		53,593	323,172
Other comprehensive gain				4,183			2,551	6,734
Issuances of non-vested restricted shares of common stock	184,265	92	(92)					—
Forfeitures of non-vested restricted shares of common stock	(3,589)	(2)	2					—
Common stock contribution to 401(k) plan	25,216	13	4,530					4,543
Stock issuances from exercise of stock options and employee stock purchase plan	144,894	72	21,528					21,600
Retirement of common stock	(23,148)	(11)	(4,631)					(4,642)
Share-based compensation			21,862					21,862
Cash dividends declared and paid on Common and Class B common stock, \$6.925 per share					(265,713)			(265,713)
Adjustment to fair value of Common stock issued for N&S Supply of Fishkill, Inc.			(161)					(161)
Distributions to non-controlling interest							(42,401)	(42,401)
Balance at December 31, 2020	38,521,694	\$ 21,697	\$950,915	\$ (34,867)	\$ 636,373	\$ (87,440)	\$293,083	\$1,779,761

See accompanying notes to consolidated financial statements.

WATSCO, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS

<i>(In thousands)</i>	Years Ended December 31,		
	2020	2019	2018
Cash flows from operating activities:			
Net income	\$ 323,172	\$ 295,775	\$ 296,529
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	25,908	24,512	22,095
Share-based compensation	22,129	17,032	15,508
Non-cash contribution to 401(k) plan	4,543	4,274	2,945
Provision for doubtful accounts	2,688	3,948	2,619
Loss (gain) on sale of property and equipment	17	(585)	27
Deferred income tax provision	40	1,278	8,290
Other income from investment in unconsolidated entity	(11,264)	(10,256)	(9,282)
Changes in operating assets and liabilities, net of effects of acquisitions:			
Accounts receivable	(3,559)	8,457	(28,831)
Inventories, net	139,929	(15,525)	(78,954)
Accounts payable and other liabilities	33,936	12,734	(57,398)
Other, net	(3,160)	(5,873)	(2,991)
Net cash provided by operating activities	534,379	335,771	170,557
Cash flows from investing activities:			
Capital expenditures	(16,436)	(17,805)	(17,153)
Business acquisitions, net of cash acquired	—	(59,672)	(5,626)
Investment in unconsolidated entity	—	(4,940)	(3,760)
Proceeds from sale of property and equipment	94	1,380	228
Net cash used in investing activities	(16,342)	(81,037)	(26,311)
Cash flows from financing activities:			
Dividends on Common and Class B common stock	(265,713)	(241,412)	(209,218)
Net (repayments) proceeds under current revolving credit agreement	(155,700)	20,500	135,200
Distributions to non-controlling interest	(42,401)	(39,272)	(46,825)
Repurchases of common stock to satisfy employee withholding tax obligations	(2,299)	(1,528)	(3,782)
Net (repayments) proceeds of other long-term obligations	(1,441)	(1,240)	269
Payment of fees related to revolving credit agreement	(196)	—	(790)
Purchase of additional ownership from non-controlling interest	—	(32,400)	—
Net repayments under prior revolving credit agreement	—	—	(21,800)
Proceeds from non-controlling interest for investment in unconsolidated entity	—	988	752
Proceeds from non-controlling interest for investment in Peirce-Phelps, Inc.	—	17,000	—
Net proceeds from issuances of common stock	19,257	13,341	6,591
Net cash used in financing activities	(448,493)	(264,023)	(139,603)
Effect of foreign exchange rate changes on cash and cash equivalents	2,069	849	(2,245)
Net increase (decrease) in cash and cash equivalents	71,613	(8,440)	2,398
Cash and cash equivalents at beginning of year	74,454	82,894	80,496
Cash and cash equivalents at end of year	\$ 146,067	\$ 74,454	\$ 82,894
Supplemental cash flow information (Note 22)			

See accompanying notes to consolidated financial statements.

WATSCO, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In thousands, except share and per share data)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization, Consolidation and Presentation

Watsco, Inc. (collectively with its subsidiaries, “Watsco,” “we,” “us,” or “our”) was incorporated in Florida 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 in North America. At December 31, 2020, we operated from 600 locations in 38 U.S. states, Canada, Mexico, and Puerto Rico with additional market coverage on an export basis to portions of Latin America and the Caribbean.

On April 3, 2020, United Technologies Corporation completed the spin-off of Carrier Corporation into an independent, publicly traded company, now named Carrier Global Corporation, which we refer to as Carrier. The consolidated financial statements include the accounts of Watsco, all of its wholly owned subsidiaries and the accounts of three joint ventures with Carrier. Carrier InterAmerica Corporation (“CIAC”), the export division of our first joint venture with Carrier, redomesticated from the U.S. Virgin Islands to Delaware effective December 31, 2019, following which CIAC became a separate operating entity in which we have an 80% controlling interest and Carrier has a 20% non-controlling interest. All significant intercompany balances and transactions have been eliminated in consolidation.

Impact of COVID-19 Pandemic

A novel strain of coronavirus, COVID-19, surfaced in December 2019 and has spread around the world, including to the United States. In March 2020, the World Health Organization declared COVID-19 a pandemic. The COVID-19 pandemic has impacted and could further impact our operations and the operations of our suppliers and customers as a result of quarantines, facility closures, illnesses, and travel and logistics restrictions. The extent to which the COVID-19 pandemic continues to impact our business, results of operations, and financial condition will depend on future developments, which are highly uncertain and cannot be predicted, including, but not limited to the magnitude, duration, spread, severity, and impact of the COVID-19 pandemic, the effects of the COVID-19 pandemic on our employees, customers, suppliers, and vendors, and to what extent normal economic and operating conditions can resume. Even after the COVID-19 pandemic has subsided, we may continue to experience adverse impacts to our business as a result of any economic recession or depression that has occurred as a result of the COVID-19 pandemic. Therefore, we cannot reasonably estimate the impact at this time.

Foreign Currency Translation and Transactions

The functional currency of our operations in Canada is the Canadian dollar. Foreign currency denominated assets and liabilities are translated into U.S. dollars at the exchange rates in effect at the balance sheet date, and income and expense items are translated at the average exchange rates in effect during the applicable period. The aggregate effect of foreign currency translation is recorded in accumulated other comprehensive loss in our consolidated balance sheets. Our net investment in our Canadian operations is recorded at the historical rate and the resulting foreign currency translation adjustments are included in accumulated other comprehensive loss in our consolidated balance sheets. Gains or losses resulting from transactions denominated in U.S. dollars are recognized in earnings primarily within cost of sales in our consolidated statements of income.

Our operations in Mexico consider their functional currency to be the U.S. dollar because the majority of their transactions are denominated in U.S. dollars. Gains or losses resulting from transactions denominated in Mexican pesos are recognized in earnings primarily within selling, general and administrative expenses in our consolidated statements of income.

Equity Method Investments

Investments in which we have the ability to exercise significant influence, but do not control, are accounted for under the equity method of accounting and are included in investment in unconsolidated entity in our consolidated balance sheets. Under this method of accounting, our proportionate share of the net income or loss of the investee is included in other income in our consolidated statements of income. The excess, if any, of the carrying amount of our investment over our ownership percentage in the underlying net assets of the investee is attributed to certain fair value adjustments with the remaining portion recognized as goodwill.

Use of Estimates

The preparation of consolidated 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 consolidated financial statements and the reported amounts of revenues and expenses for the reporting period. Significant estimates include valuation reserves for accounts receivable, net realizable value adjustments to inventories, income taxes, reserves related to loss contingencies and the valuation of goodwill, indefinite-lived intangible assets and long-lived assets. While we believe that these estimates are reasonable, actual results could differ from such estimates.

Cash Equivalents

All highly liquid instruments purchased with original maturities of three months or less are considered to be cash equivalents.

Accounts Receivable and Allowance for Doubtful Accounts

Accounts receivable primarily consist of trade receivables due from customers and are stated at the invoiced amount less an allowance for doubtful accounts. An allowance for doubtful accounts is maintained for estimated losses resulting from the inability of customers to make required payments. When preparing these estimates, we consider a number of factors, including the aging of a customer's account, past transactions with customers, creditworthiness of specific customers, historical trends and other information, including potential impacts of business and economic conditions. Upon determination that an account is uncollectible, the receivable balance is written off. At December 31, 2020 and 2019, the allowance for doubtful accounts totaled \$7,087 and \$7,943, respectively.

Inventories

Inventories consist of air conditioning, heating and refrigeration equipment and related parts and supplies and are valued at the lower of cost using the weighted-average cost basis and the first-in, first-out methods, or net realizable value. As part of the valuation process, inventories are adjusted to reflect excess, slow-moving and damaged inventories at their estimated net realizable value. Inventory policies are reviewed periodically, reflecting current risks, trends and changes in industry conditions. A reserve for estimated inventory shrinkage is also maintained to consider inventory shortages determined from cycle counts and physical inventories.

Vendor Rebates and Purchase Discounts

We have arrangements with several vendors that provide rebates payable to us when we achieve any of a number of measures, generally related to the volume level of purchases. We account for such rebates as a reduction of inventory until we sell the product, at which time such rebates are reflected as a reduction of cost of sales in our consolidated statements of income. Throughout the year, we estimate the amount of the rebate based on our estimate of purchases to date relative to the purchase levels that mark our progress toward earning the rebates. We continually revise our estimates of earned vendor rebates based on actual purchase levels. At December 31, 2020 and 2019, we had \$13,434 and \$12,007, respectively, of rebates recorded as a reduction of inventory. Substantially all vendor rebate receivables are collected within three months immediately following the end of the year. Vendor rebates that are earned based on products sold are credited directly to cost of sales in our consolidated statements of income.

We also have vendors that offer a cash discount when we pay their invoice within a specified period of time. We account for such cash discounts as a reduction of inventory until we sell the product at which time such cash discounts are reflected as a reduction of cost of sales in our consolidated statements of income. At December 31, 2020 and 2019, we had \$12,029 and \$10,098, respectively, of cash discounts recorded as a reduction of inventory.

Equity Securities

Investments in equity securities are recorded at fair value using the specific identification method and are included in other assets in our consolidated balance sheets. Changes in the fair value of equity securities and dividend income are recognized in our consolidated statements of income.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization of property and equipment is computed using the straight-line method. Buildings and improvements are depreciated or amortized over estimated useful lives ranging from 3-40 years. Leasehold improvements are amortized over the shorter of the respective lease terms or estimated useful lives. Machinery, vehicles, and equipment are depreciated over estimated useful lives ranging from 3-10 years. Computer hardware and software are depreciated over estimated useful lives ranging from 3-10 years. Furniture and fixtures are depreciated over estimated useful lives ranging from 5-7 years.

Operating and Finance Leases

We have operating leases for real property, vehicles and equipment, and finance leases primarily for vehicles. Operating leases are included in operating lease right-of-use (“ROU”) assets, current portion of long-term obligations, and operating lease liabilities, net of current portion in our consolidated balance sheets. Finance leases are not considered significant to our consolidated balance sheets or consolidated statements of income. Finance lease ROU assets at December 31, 2020 and 2019, of \$6,232 and \$3,150, respectively, are included in property and equipment, net in our consolidated balance sheets. Finance lease liabilities at December 31, 2020 and 2019, of \$6,383 and \$3,231, respectively, are included in current portion of long-term obligations and finance lease liabilities, net of current portion in our consolidated balance sheets.

ROU assets represent our right to use an underlying asset for the lease term, and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at the applicable commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit interest rate, we use our incremental borrowing rate based on the information available at the commencement dates of the respective leases in determining the present value of the applicable lease payments.

Operating lease ROU assets also include any lease pre-payments made and exclude lease incentives. Certain of our leases include variable payments, which are excluded from lease ROU assets and lease liabilities and expensed as incurred. Our leases have remaining lease terms of 1-9 years, some of which include options to extend the leases for up to five years. The exercise of lease renewal options is at our sole discretion, and our lease ROU assets and liabilities reflect only the options we are reasonably certain that we will exercise. Certain real property lease agreements have lease and non-lease components, which are generally accounted for as a single lease component. Lease expense for lease payments is recognized on a straight-line basis over the lease term. Lease payments for short-term leases, which are 12 months or less without a purchase option that is likely to be exercised, are recognized as lease cost on a straight-line basis over the lease term.

Practical Expedients

We elected the practical expedients related to short-term leases and separating lease components from non-lease components for all underlying asset classes.

Goodwill and Intangible Assets

Goodwill is recorded when the purchase price paid for an acquisition exceeds the fair value of the net identified tangible and intangible assets acquired. We evaluate goodwill for impairment annually or more frequently when an event occurs or circumstances change that indicate that the carrying value may not be recoverable. We test goodwill for impairment by comparing the fair value of our reporting unit to its carrying value. If the fair value is determined to be less than the carrying value, an impairment charge would be recognized. On January 1, 2021, we performed our annual evaluation of goodwill impairment and determined that the estimated fair value of our reporting unit significantly exceeded its carrying value.

Intangible assets primarily consist of the value of trade names and trademarks, distributor agreements, customer relationships and patented and unpatented technology. Indefinite lived intangibles not subject to amortization are assessed for impairment at least annually, or more frequently if events or changes in circumstances indicate they may be impaired, by comparing the fair value of the intangible asset to its carrying amount to determine if a write-down to fair value is required. Finite lived intangible assets are amortized using the straight-line method over their respective estimated useful lives.

We perform our annual impairment tests each year and have determined there to be no impairment for any of the periods presented. There were no events or circumstances identified from the date of our assessment that would require an update to our annual impairment tests.

Long-Lived Assets

Long-lived assets, other than goodwill and intangible assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Recoverability is evaluated by determining whether the amortization of the balance over its remaining life can be recovered through undiscounted future operating cash flows. We measure the impairment loss based on projected discounted cash flows using a discount rate reflecting the average cost of funds and compared to the asset’s carrying value. As of December 31, 2020, there were no such events or circumstances.

Fair Value Measurements

We carry various assets and liabilities at fair value in the consolidated balance sheets. Fair value is defined as the price that would be received for 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:

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- 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.
- 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.

Revenue Recognition

Revenue primarily consists of sales of air conditioning, heating and refrigeration equipment, and related parts and supplies. We generate our revenue primarily from the sale of finished products to customers; therefore, the significant majority of our contracts are short-term in nature and have only a single performance obligation to deliver products; therefore, we satisfy our performance obligation under such contracts when we transfer control of the product to the customer. Some contracts contain a combination of product sales and services, the latter of which is distinct and accounted for as a separate performance obligation. We satisfy our performance obligations for services when we render the services within the agreed-upon service period. Total service revenue is not material and accounted for less than 1% of our consolidated revenues for both 2020 and 2019.

Revenue is recognized when control transfers to our customers when products are picked up or via shipment of products or delivery of services. We measure revenue as the amount of consideration we expect to be entitled to receive in exchange for those goods or services, net of any variable considerations (e.g., rights to return product, sales incentives, others) and any taxes collected from customers and subsequently remitted to governmental authorities. Revenue for shipping and handling charges is recognized when products are delivered to the customer.

Product Returns

We estimate product returns based on historical experience and record them on a gross basis on our balance sheets. Substantially all customer returns relate to products that are returned under manufacturers' warranty obligations. Accrued sales returns at December 31, 2020 and 2019 of \$12,739 and \$12,181, respectively, were included in accrued expenses and other current liabilities in our consolidated balance sheets.

Sales Incentives

We estimate sales incentives expected to be paid over the term of the program based on the most likely amounts. Sales incentives are accounted for as a reduction in the transaction price and are generally paid on an annual basis.

Practical Expedients

We generally expense sales commissions when incurred because the amortization period is one year or less. These costs are recorded within selling, general and administrative expenses. We do not disclose the value of unsatisfied performance obligations for contracts with an original expected length of one year or less.

Advertising Costs

Advertising costs are expensed as incurred. Advertising expense for the years ended December 31, 2020, 2019, and 2018, were \$12,588, \$16,587, and \$16,520, respectively.

Shipping and Handling

Shipping and handling costs associated with inbound freight are capitalized to inventories and relieved through cost of sales as inventories are sold. Shipping and handling costs associated with the delivery of products are included in selling, general and administrative expenses. Shipping and handling costs included in selling, general and administrative expenses for the years ended December 31, 2020, 2019, and 2018, were \$55,019, \$54,783, and \$51,741, respectively.

Share-Based Compensation

The fair value of stock option and non-vested restricted stock awards are expensed net of estimated forfeitures on a straight-line basis over the vesting period of the awards. Share-based compensation expense is included in selling, general and administrative expenses in our consolidated statements of income. Tax benefits resulting from tax deductions in excess of share-based compensation expense are recognized in our provision for income taxes in our consolidated statements of income.

Income Taxes

We record U.S. federal, state and foreign income taxes currently payable, as well as deferred taxes due to temporary differences between reporting income and expenses for financial statement purposes versus tax purposes. Deferred tax assets and liabilities reflect the temporary differences between the financial statement and income tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a change in tax rates is recognized as income or expense in the period that includes the enactment date. We and our eligible subsidiaries file a consolidated U.S. federal income tax return. As income tax returns are generally not filed until well after the closing process for the

December 31 financial statements is complete, the amounts recorded at December 31 reflect estimates of what the final amounts will be when the actual income tax returns are filed for that calendar year. In addition, estimates are often required with respect to, among other things, the appropriate state income tax rates to use in the various states that we and our subsidiaries are required to file, the potential utilization of operating loss carryforwards and valuation allowances required, if any, for tax assets that may not be realizable in the future.

We recognize the financial statement benefit of a tax position only after determining that the relevant tax authority would more likely than not sustain the position following an audit. For tax positions meeting the “more-likely-than-not” threshold, the amount recognized in the financial statements is the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement with the relevant tax authority.

Earnings per Share

We compute earnings per share 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 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 reflects the dilutive effect of potential common shares from stock options. The dilutive effect of outstanding stock options is computed using the treasury stock method, which assumes any proceeds that could be obtained upon the exercise of stock options, would be used to purchase common stock at the average market price for the period. The assumed proceeds include the purchase price the optionee pays, the windfall tax benefit that we receive upon assumed exercise and the unrecognized compensation expense at the end of each period.

Derivative Instruments and Hedging Activity

We have used derivative instruments, including forward and option contracts and swaps, to manage our exposure to fluctuations in foreign currency exchange rates and interest rates. The use of these derivative instruments modifies the exposure of these risks with the intent to reduce the risk or cost to us. We use derivative instruments as risk management tools and not for trading purposes. All derivatives, whether designated as hedging relationships or not, are recorded on the balance sheet at fair value. Cash flows from derivative instruments are classified in the consolidated statements of cash flows in the same category as the cash flows from the items subject to the designated hedge or undesignated (economic) hedge relationships. The hedging designation may be classified as one of the following:

No Hedging Designation. The gain or loss on a derivative instrument not designated as an accounting hedging instrument is recognized in earnings within selling, general and administrative expenses.

Cash Flow Hedge. A hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability is considered a cash flow hedge. The effective portion of the change in the fair value of a derivative that is designated as a cash flow hedge is recorded in other comprehensive income (loss) and reclassified to earnings as a component of cost of sales in the period for which the hedged transaction affects earnings. Ineffective portions of changes in the fair value of cash flow hedges are recognized in earnings.

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Fair Value Hedge. A hedge of a recognized asset or liability or an unrecognized firm commitment is considered a fair value hedge. Fair value hedges, both the effective and ineffective portions of the changes in the fair value of the derivative, along with the gain or loss on the hedged item that is attributable to the hedged risk, are recorded in earnings.

See Note 17 for additional information pertaining to derivative instruments.

Loss Contingencies

Accruals are recorded for various contingencies including self-insurance, legal proceedings, environmental matters, and other claims that arise in the normal course of business. The estimation process contains uncertainty because accruals are based on judgment, the probability of losses and, where applicable, the consideration of opinions of external legal counsel and actuarially determined estimates. Additionally, we record receivables from third party insurers when recovery has been determined to be probable.

Recently Adopted Accounting Standards

Financial Instruments—Credit Losses

In June 2016, the Financial Accounting Standards Board (“FASB”) issued guidance that modifies the impairment model to utilize an expected loss methodology in place of the incurred loss methodology for financial instruments, including trade receivables, contract assets, long-term receivables and off-balance sheet credit exposures. Under the new standard, an entity will be required to consider a broader range of information to estimate expected credit losses, including historical information, current conditions, and a reasonable forecast period, which may result in earlier recognition of certain losses. This guidance is effective for interim and annual periods beginning after December 15, 2019 using a modified retrospective approach. The adoption of this guidance did not have a material impact on our consolidated financial statements.

Intangibles—Goodwill and Other

In January 2017, the FASB issued guidance to simplify the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under this updated standard, an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value, but the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity also should consider income tax effects from any tax-deductible goodwill on the carrying amount of the reporting unit when measuring the goodwill impairment loss, if any. This guidance is effective prospectively and is effective for interim and annual periods beginning after December 15, 2019. The adoption of this guidance did not have a material impact on our consolidated financial statements.

2. LEASES

The components of operating lease expense were as follows:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>
Lease cost	\$82,543	\$74,755
Short-term lease cost	6,317	9,427
Variable lease cost	942	707
Sublease income	(228)	(226)
Total operating lease cost	<u>\$89,574</u>	<u>\$84,663</u>

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Supplemental balance sheet information related to operating leases were as follows:

<u>December 31,</u>	<u>2020</u>	<u>2019</u>
ROU assets	\$ 209,169	\$ 223,369
Current portion of operating lease liabilities	\$ 70,232	\$ 68,199
Operating lease liabilities	139,527	154,271
Total operating lease liabilities	\$ 209,759	\$ 222,470
Weighted Average Remaining Lease Term (in years)	3.5 years	3.9 years
Weighted Average Discount Rate	4.00%	4.48%

Supplemental cash flow information related to operating leases were as follows:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>
Operating cash flows for the measurement of operating lease liabilities	\$80,921	\$ 75,357
Operating lease ROU assets obtained in exchange for operating lease obligations	\$59,093	\$290,422

At December 31, 2020, maturities of operating lease liabilities over each of the next five years and thereafter were as follows:

2021	\$ 77,170
2022	62,291
2023	44,931
2024	25,052
2025	9,709
Thereafter	6,842
Total lease payments	225,995
Less imputed interest	16,236
Total lease liability	\$209,759

At December 31, 2020, we had additional operating leases, primarily for real property, that had not yet commenced. Such leases had estimated future minimum rental commitments of approximately \$21,300. These operating leases are expected to commence in 2021 with lease terms of 5-11 years. These undiscounted amounts are not included in the table above.

3. REVENUES

Disaggregation of Revenues

The following table presents our revenues disaggregated by primary geographical regions and major product lines within our single reporting segment:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Primary Geographical Regions:			
United States	\$4,535,262	\$4,184,206	\$3,981,056
Canada	301,727	294,040	291,685
Latin America and the Caribbean	217,939	292,116	273,912
	<u>\$5,054,928</u>	<u>\$4,770,362</u>	<u>\$4,546,653</u>
Major Product Lines:			
HVAC equipment	69%	68%	67%
Other HVAC products	28%	28%	29%
Commercial refrigeration products	3%	4%	4%
	<u>100%</u>	<u>100%</u>	<u>100%</u>

4. EARNINGS PER SHARE

The following table presents the calculation of basic and diluted earnings per share for our Common and Class B common stock:

<i>Years Ended December 31,</i>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Basic Earnings per Share:			
Net income attributable to Watsco, Inc. shareholders	\$ 269,579	\$ 245,950	\$ 242,932
Less: distributed and undistributed earnings allocated to non-vested restricted common stock	<u>23,140</u>	<u>20,412</u>	<u>19,792</u>
Earnings allocated to Watsco, Inc. shareholders	<u>\$ 246,439</u>	<u>\$ 225,538</u>	<u>\$ 223,140</u>
Weighted-average common shares outstanding - Basic	<u>35,069,516</u>	<u>34,644,700</u>	<u>34,319,890</u>
Basic earnings per share for Common and Class B common stock	<u>\$ 7.03</u>	<u>\$ 6.51</u>	<u>\$ 6.50</u>
Allocation of earnings for Basic:			
Common stock	\$ 228,361	\$ 208,779	\$ 206,355
Class B common stock	<u>18,078</u>	<u>16,759</u>	<u>16,785</u>
	<u>\$ 246,439</u>	<u>\$ 225,538</u>	<u>\$ 223,140</u>
Diluted Earnings per Share:			
Net income attributable to Watsco, Inc. shareholders	\$ 269,579	\$ 245,950	\$ 242,932
Less: distributed and undistributed earnings allocated to non-vested restricted common stock	<u>23,140</u>	<u>20,411</u>	<u>19,788</u>
Earnings allocated to Watsco, Inc. shareholders	<u>\$ 246,439</u>	<u>\$ 225,539</u>	<u>\$ 223,144</u>
Weighted-average common shares outstanding - Basic	<u>35,069,516</u>	<u>34,644,700</u>	<u>34,319,890</u>
Effect of dilutive stock options	<u>81,055</u>	<u>30,941</u>	<u>54,379</u>
Weighted-average common shares outstanding - Diluted	<u>35,150,571</u>	<u>34,675,641</u>	<u>34,374,269</u>
Diluted earnings per share for Common and Class B common stock	<u>\$ 7.01</u>	<u>\$ 6.50</u>	<u>\$ 6.49</u>

Diluted earnings per share for our Common stock assumes the conversion of all our Class B common stock into Common stock as of the beginning of the fiscal year; therefore, no allocation of earnings to Class B common stock is required. At December 31, 2020, 2019, and 2018, our outstanding Class B common stock was convertible into 2,572,536, 2,574,336, and 2,581,627 shares of our Common stock, respectively.

Diluted earnings per share excluded 19,722, 205,380, and 74,270 shares for the years ended December 31, 2020, 2019, and 2018, 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.

5. OTHER COMPREHENSIVE INCOME (LOSS)

Other comprehensive income (loss) consists of the foreign currency translation adjustment associated with our Canadian operations' use of the Canadian dollar as their functional currency and changes in the unrealized gains (losses) on cash flow hedging instruments. The tax effects allocated to each component of other comprehensive income (loss) were as follows:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Foreign currency translation adjustment	<u>\$6,272</u>	<u>\$12,298</u>	<u>\$(20,493)</u>
Unrealized gain (loss) on cash flow hedging instruments	<u>1,205</u>	<u>(2,001)</u>	<u>2,627</u>
Income tax (expense) benefit	<u>(325)</u>	<u>540</u>	<u>(709)</u>
Unrealized gain (loss) on cash flow hedging instruments, net of tax	<u>880</u>	<u>(1,461)</u>	<u>1,918</u>
Reclassification of gain on cash flow hedging instruments into earnings	<u>(574)</u>	<u>(482)</u>	<u>(215)</u>
Income tax expense	<u>156</u>	<u>130</u>	<u>58</u>
Reclassification of gain on cash flow hedging instruments into earnings, net of tax	<u>(418)</u>	<u>(352)</u>	<u>(157)</u>
Other comprehensive income (loss)	<u>\$6,734</u>	<u>\$10,485</u>	<u>\$(18,732)</u>

The changes in each component of accumulated other comprehensive loss, net of tax, were as follows:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Foreign currency translation adjustment:			
Beginning balance	<u>\$(38,599)</u>	<u>\$(46,604)</u>	<u>\$(33,499)</u>
Current period other comprehensive income (loss)	<u>3,905</u>	<u>8,005</u>	<u>(13,105)</u>
Ending balance	<u>\$(34,694)</u>	<u>\$(38,599)</u>	<u>\$(46,604)</u>
Cash flow hedging instruments:			
Beginning balance	<u>(451)</u>	<u>636</u>	<u>(421)</u>
Current period other comprehensive income (loss)	<u>528</u>	<u>(876)</u>	<u>1,151</u>
Reclassification adjustment	<u>(250)</u>	<u>(211)</u>	<u>(94)</u>
Ending balance	<u>(173)</u>	<u>(451)</u>	<u>636</u>
Equity securities:			
Beginning balance	<u>—</u>	<u>—</u>	<u>(301)</u>
Cumulative-effect adjustment to retained earnings	<u>—</u>	<u>—</u>	<u>301</u>
Ending balance	<u>—</u>	<u>—</u>	<u>—</u>
Accumulated other comprehensive loss, net of tax	<u>\$ (34,867)</u>	<u>\$ (39,050)</u>	<u>\$ (45,968)</u>

6. SUPPLIER CONCENTRATION

Purchases from our top ten suppliers comprised 85%, 83%, and 84% of all purchases made in 2020, 2019, and 2018, respectively. Our largest supplier, Carrier and its affiliates, accounted for 63%, 62%, and 62% of all purchases made in 2020, 2019, and 2018, respectively. See Note 20. A significant interruption by Carrier, or any of our other key suppliers, in the delivery of products could impair our ability to maintain current inventory levels and could materially impact our consolidated results of operations and consolidated financial position.

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7. PROPERTY AND EQUIPMENT

Property and equipment, net, consists of:

<i>December 31,</i>	<u>2020</u>	<u>2019</u>
Land	\$ 741	\$ 741
Buildings and improvements	80,877	81,938
Machinery, vehicles, and equipment	92,577	86,639
Computer hardware and software	62,776	56,227
Furniture and fixtures	19,077	18,049
	<u>256,048</u>	<u>243,594</u>
Accumulated depreciation and amortization	<u>(157,823)</u>	<u>(145,071)</u>
	<u>\$ 98,225</u>	<u>\$ 98,523</u>

Depreciation and amortization expense related to property and equipment included in selling, general and administrative expenses for the years ended December 31, 2020, 2019, and 2018, were \$19,963, \$18,808, and \$16,747, respectively.

8. DEBT

We maintain an unsecured, syndicated multicurrency revolving credit agreement, which we use to fund seasonal working capital needs and for other general corporate purposes, including acquisitions, dividends (if and as declared by our Board of Directors), capital expenditures, stock repurchases and issuances of letters of credit. On April 10, 2020, we increased the aggregate borrowing capacity of our revolving credit agreement from \$500,000 to \$560,000. The credit facility has a seasonal component from October 1 to March 31, during which the borrowing capacity may be reduced to \$460,000 at our discretion, and we effected this reduction in 2020. Included in the credit facility are a \$100,000 swingline subfacility, a \$10,000 letter of credit subfacility, a \$75,000 alternative currency borrowing sublimit and an \$8,000 Mexican borrowing sublimit. The credit agreement matures on December 5, 2023.

Borrowings under the credit facility bear interest at either LIBOR-based rates plus a spread, which ranges from 87.5 to 150.0 basis-points (LIBOR plus 87.5 basis-points at December 31, 2020), depending on our ratio of total debt to EBITDA, or on rates based on the highest of the Federal Funds Effective Rate plus 0.5%, the Prime Rate or the Eurocurrency Rate plus 1.0%, in each case plus a spread which ranges from 0 to 50.0 basis-points (0 basis-points at December 31, 2020), depending on our ratio of total debt to EBITDA. We pay a variable commitment fee on the unused portion of the commitment under the revolving credit agreement, ranging from 7.5 to 20.0 basis-points (7.5 basis-points at December 31, 2020). During 2020, we paid fees of \$196 in connection with the increase in the aggregate borrowing capacity of our revolving credit agreement, which are being amortized ratably through the maturity of the facility in December 2023.

At December 31, 2020 there was no outstanding balance under the revolving credit agreement. At December 31, 2019 \$155,700 was outstanding under the revolving credit agreement. The revolving credit agreement contains customary affirmative and negative covenants, including financial covenants with respect to consolidated leverage and interest coverage ratios, and other customary restrictions. We believe we were in compliance with all covenants at December 31, 2020.

[Table of Contents](#)**9. INCOME TAXES**

The components of income tax expense from our wholly owned operations and investments and our controlling interest in CIAC and joint ventures with Carrier are as follows:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Current:			
U.S. Federal	\$58,895	\$48,359	\$47,263
State	12,909	9,362	10,031
Foreign	4,779	8,078	7,229
	<u>76,583</u>	<u>65,799</u>	<u>64,523</u>
Deferred:			
U.S. Federal	218	2,603	7,082
State	21	446	1,600
Foreign	(199)	(1,771)	(392)
	<u>40</u>	<u>1,278</u>	<u>8,290</u>
Income tax expense	<u>\$76,623</u>	<u>\$67,077</u>	<u>\$72,813</u>

We calculate our income tax expense and our effective tax rate for 100% of income attributable to our wholly owned operations and for our controlling interest of income attributable to CIAC and our joint ventures with Carrier, which are primarily taxed as partnerships for income tax purposes.

Following is a reconciliation of the effective income tax rate:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
U.S. federal statutory rate	21.0%	21.0%	21.0%
State income taxes, net of federal benefit and other	3.3	2.8	3.6
Excess tax benefits from share-based compensation	(2.3)	(2.0)	(2.0)
Tax effects on foreign income	0.3	0.5	0.5
GILTI	—	(0.1)	0.3
Tax credits and other	(0.3)	(1.0)	—
Repatriation transition tax	—	—	(0.9)
Deferred tax impact of enacted tax rate changes	—	—	0.3
Effective income tax rate attributable to Watsco, Inc.	22.0	21.2	22.8
Taxes attributable to non-controlling interest	(2.8)	(2.7)	(3.1)
Effective income tax rate	<u>19.2%</u>	<u>18.5%</u>	<u>19.7%</u>

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The following is a summary of the significant components of our net deferred tax liabilities:

<i>December 31,</i>	2020	2019
Deferred tax assets:		
Share-based compensation	\$ 27,223	\$ 24,413
Capitalized inventory costs and inventory reserves	3,189	3,627
Allowance for doubtful accounts	949	1,338
Self-insurance reserves	518	209
Other	5,090	2,212
Net operating loss carryforwards	2,930	2,036
	<u>39,899</u>	<u>33,835</u>
Valuation allowance	(668)	(655)
Total deferred tax assets	<u>39,231</u>	<u>33,180</u>
Deferred tax liabilities:		
Deductible goodwill	(78,288)	(73,898)
Depreciation	(16,441)	(14,241)
Other	(7,050)	(7,188)
Total deferred tax liabilities	<u>(101,779)</u>	<u>(95,327)</u>
Net deferred tax liabilities (1)	<u>\$ (62,548)</u>	<u>\$ (62,147)</u>

(1) *Net deferred tax liabilities have been included in the consolidated balance sheets in deferred income taxes and other liabilities.*

On December 22, 2017, Public Law 115-97 “An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018” was enacted. This law is commonly referred to as the Tax Cuts and Jobs Act of 2017 (the “TCJA”). The TCJA made broad and complex changes to the U.S. tax code including but not limited to, reducing the U.S. federal corporate tax rate from 35% to 21% effective January 1, 2018, and requiring a one-time repatriation transition tax on certain undistributed earnings of foreign subsidiaries. The TCJA also put in place new tax laws that applied prospectively, which included, but were not limited to, generally eliminating U.S. federal income taxes on dividends from foreign subsidiaries and a new provision designed to tax U.S. allocated expenses as well as currently taxing certain global intangible low-taxed income (“GILTI”) of foreign subsidiaries. GILTI is a tax on foreign income in excess of a deemed return on tangible assets of foreign corporations. We have elected to provide for the tax expense related to GILTI in the year the tax is incurred as a period expense.

In 2018, we increased our previously estimated net income tax benefit for the enactment-date effects of the TCJA by \$1,819 to \$11,774, following the refinement of estimated U.S. federal and state income taxes on previously undistributed earnings of our foreign subsidiaries. There were no additional refinements for any enactment-date effects related to the TCJA in 2019 or 2020.

The TCJA one-time repatriation transition tax and GILTI liabilities effectively taxed the undistributed earnings previously deferred from U.S. federal and certain state income taxes. As of December 31, 2020, we have accumulated undistributed earnings generated by our foreign subsidiaries of approximately \$85,000. Any additional taxes due with respect to such previously taxed earnings, if repatriated, would generally be limited to certain state income taxes and foreign withholding. Deferred taxes have been recorded for foreign withholding taxes on certain earnings of our foreign consolidated subsidiaries expected to be repatriated. We do not intend to distribute the remaining previously taxed foreign earnings and therefore have not recorded deferred taxes for certain state income taxes and foreign withholding on such earnings. The amount of certain state income taxes and foreign withholding that might be payable on the remaining amounts at December 31, 2020 is not practicable to estimate.

Valuation allowances are provided to reduce the related deferred income tax assets to an amount which will, more likely than not, be realized. At December 31, 2020 and 2019, we had a valuation allowance of \$668 and \$655, respectively, to reduce our deferred tax assets to an amount that is more likely than not to be recovered. At December 31, 2020, there were state net operating loss carryforwards of \$14,427, which expire in varying amounts from 2021 through 2040. At December 31, 2020, there were foreign net operating loss carryforwards of \$10,565, which expire in varying amounts from 2036 through 2040. These amounts are available to offset future taxable income. There were no federal net operating loss carryforwards at December 31, 2020.

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We are subject to United States federal income tax, income tax of multiple state jurisdictions and foreign income tax. We are subject to tax audits in the various jurisdictions until the respective statutes of limitations expire. We are no longer subject to United States federal tax examinations for tax years prior to 2016. For the majority of states and foreign jurisdictions, we are no longer subject to tax examinations for tax years prior to 2015.

At December 31, 2020 and 2019, the total amount of gross unrecognized tax benefits (excluding the federal benefit received from state positions) was \$6,505 and \$5,367, respectively. Of these totals, \$5,461 and \$4,367, respectively, (net of the federal benefit received from state positions) represent the amount of unrecognized tax benefits that, if recognized, would affect the effective tax rate. Our continuing practice is to recognize penalties within selling, general and administrative expenses and interest related to income tax matters in income tax expense in the consolidated statements of income. At December 31, 2020 and 2019, the cumulative amount of estimated accrued interest and penalties resulting from such unrecognized tax benefits was \$982 and \$855, respectively, and is included in deferred income taxes and other current liabilities in the accompanying consolidated balance sheets.

The changes in gross unrecognized tax benefits were as follows:

Balance at December 31, 2017	\$4,225
Additions based on tax positions related to the current year	960
Reductions due to lapse of applicable statute of limitations	(283)
Balance at December 31, 2018	4,902
Additions based on tax positions related to the current year	1,027
Reductions due to lapse of applicable statute of limitations	(562)
Balance at December 31, 2019	5,367
Additions based on tax positions related to the current year	1,911
Reductions due to lapse of applicable statute of limitations	(773)
Balance at December 31, 2020	<u>\$6,505</u>

10. SHARE-BASED COMPENSATION AND BENEFIT PLANS

Share-Based Compensation Plans

We maintain the 2014 Incentive Compensation Plan (the “2014 Plan”) that provides for the award of a broad variety of share-based compensation alternatives such as non-vested restricted stock, non-qualified stock options, incentive stock options, performance awards, dividend equivalents, deferred stock and stock appreciation rights at no less than 100% of the market price on the date the award is granted. To date, awards under the 2014 Plan consist of non-qualified stock options and non-vested restricted stock.

Under the 2014 Plan, the number of shares of Common and Class B common stock available for issuance is (i) 2,000,000, plus (ii) 45,421 shares of Common stock or Class B common stock that remained available for grant in connection with awards under the 2001 Plan as of the date our shareholders approved the 2014 Plan plus (iii) shares underlying currently outstanding awards issued under the 2001 Plan, which shares become reissuable under the 2014 Plan to the extent that such underlying shares are not issued due to their forfeiture, expiration, termination or otherwise. A total of 915,752 shares of Common stock, net of cancellations, and 968,166 shares of Class B common stock, had been awarded under the 2014 Plan as of December 31, 2020. As of December 31, 2020, 161,503 shares of common stock were reserved for future grants under the 2014 Plan. Options under the 2014 Plan vest over two to four years of service and have contractual terms of five years. Awards of non-vested restricted stock, which are granted at no cost to the employee, vest upon attainment of a specified age, generally toward the end of an employee’s career at age 62 or older. Vesting may be accelerated in certain circumstances prior to the original vesting date.

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The following is a summary of stock option activity under the 2014 Plan as of and for the year ended December 31, 2020:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding at December 31, 2019	584,675	\$ 159.34		
Granted	161,500	207.60		
Exercised	(135,809)	146.90		
Forfeited	(25,250)	175.76		
Options outstanding at December 31, 2020	<u>585,116</u>	<u>\$ 174.83</u>	<u>3.22</u>	<u>\$ 30,729</u>
Options exercisable at December 31, 2020	<u>89,697</u>	<u>\$ 161.15</u>	<u>2.27</u>	<u>\$ 5,866</u>

The following is a summary of non-vested restricted stock activity as of and for the year ended December 31, 2020:

	Shares	Weighted-Average Grant Date Fair Value
Non-vested restricted stock outstanding at December 31, 2019	3,191,705	\$ 68.63
Granted	184,265	193.89
Vested	(37,274)	108.36
Forfeited	(3,589)	164.94
Non-vested restricted stock outstanding at December 31, 2020	<u>3,335,107</u>	<u>\$ 75.00</u>

The weighted-average grant date fair value of non-vested restricted stock granted during 2020, 2019, and 2018 was \$193.89, \$151.58, and \$167.06, respectively. The fair value of non-vested restricted stock that vested during 2020, 2019, and 2018 was \$7,354, \$4,931, and \$9,637, respectively.

During 2020, 11,693 shares of Common and Class B common stock with an aggregate fair market value of \$2,299 were withheld as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of restricted stock. During 2019, 9,824 shares of Common and Class B common stock with an aggregate fair market value of \$1,518 were withheld as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of restricted stock. During 2018, 21,754 shares of Common and Class B common stock with an aggregate fair market value of \$3,775 were withheld as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of restricted stock. These shares were retired upon delivery.

Share-Based Compensation Fair Value Assumptions

The fair value of each stock option award is estimated on the date of grant using the Black-Scholes option pricing valuation model based on the weighted-average assumptions noted in the table below. The fair value of each stock option award, which is subject to graded vesting, is expensed, net of estimated forfeitures, on a straight-line basis over the requisite service period for each separately vesting portion of the stock option. We use historical data to estimate stock option forfeitures. The expected term of stock option awards granted represents the period of time that stock option awards granted are expected to be outstanding and was calculated using the simplified method for plain vanilla options, which we believe provides a reasonable estimate of expected life based on our historical data. The risk-free rate for periods within the contractual life of the stock option award is based on the yield curve of a zero-coupon United States Treasury bond on the date the stock option award is granted with a maturity equal to the expected term of the stock option award. Expected volatility is based on historical volatility of our stock.

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The following table presents the weighted-average assumptions used for stock options granted:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Expected term in years	4.25	4.25	4.25
Risk-free interest rate	0.26%	1.64%	2.69%
Expected volatility	20.89%	18.01%	17.11%
Expected dividend yield	3.69%	3.99%	3.13%
Grant date fair value	\$20.76	\$14.81	\$20.05

Exercise of Stock Options

The total intrinsic value of stock options exercised during 2020, 2019, and 2018 was \$8,753, \$4,153, and \$3,500, respectively. Cash received from the exercise of stock options during 2020, 2019, and 2018 was \$17,608, \$11,703, and \$5,006, respectively. The tax benefit from stock option exercises during 2020, 2019, and 2018 was \$1,586, \$626, and \$635, respectively. During 2020, 2019, and 2018, 11,455 shares of Common stock with an aggregate fair market value of \$2,343, 799 shares of Common stock with an aggregate fair market value of \$134 and 7,027 shares of Common stock with an aggregate fair market value of \$1,269, respectively, were withheld as payment in lieu of cash for stock option exercises and related tax withholdings. These shares were retired upon delivery.

Share-Based Compensation Expense

The following table provides information on share-based compensation expense:

<u>Years Ended December 31,</u>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Stock options	\$ 2,447	\$ 2,440	\$ 2,014
Non-vested restricted stock	19,682	14,592	13,494
Share-based compensation expense	<u>\$22,129</u>	<u>\$17,032</u>	<u>\$15,508</u>

At December 31, 2020, there was \$4,184 of unrecognized pre-tax compensation expense related to stock options granted under the 2014 Plan, which is expected to be recognized over a weighted-average period of approximately 1.8 years. The total fair value of stock options that vested during 2020, 2019, and 2018 was \$2,177, \$2,055, and \$1,607, respectively.

At December 31, 2020, there was \$152,187 of unrecognized pre-tax compensation expense related to non-vested restricted stock, which is expected to be recognized over a weighted-average period of approximately 11 years. Of this amount, approximately \$57,000 is related to awards granted to our Chief Executive Officer (“CEO”), of which approximately \$4,000, \$31,000, and \$22,000 vest in approximately 2, 6, and 8 years upon his attainment of age 82, 86, and 88, respectively, and approximately \$23,000 is related to awards granted to our President, of which approximately \$22,000 and \$1,000 vest in approximately 23 and 25 years upon his attainment of age 62 and 64, respectively. In the event that vesting is accelerated for any circumstance, as defined in the related agreements, the remaining unrecognized share-based compensation expense would be immediately recognized as a charge to earnings with a corresponding tax benefit. At December 31, 2020, we were obligated to issue 42,909 shares of non-vested restricted stock to our CEO that vest in 8 years and 35,025 shares of non-vested restricted stock to our President that vest in 23 years in connection with 2020’s performance-based incentive compensation program.

Employee Stock Purchase Plan

The Watsco, Inc. Fourth Amended and Restated 1996 Qualified Employee Stock Purchase Plan (the “ESPP”) provides for up to 1,500,000 shares of Common stock to be available for purchase by our full-time employees with at least 90 days of service. The ESPP allows participating employees to purchase shares of Common stock at a 5% discount to the fair market value at specified times. During 2020, 2019, and 2018, employees purchased 5,121, 5,676, and 5,151 shares of Common stock at an average price of \$171.89, \$145.09, and \$168.21 per share, respectively. Cash dividends received by the ESPP were reinvested in Common stock and resulted in the issuance of 3,964, 5,087, and 4,338 additional shares during 2020, 2019, and 2018, respectively. We received net proceeds of \$1,649, \$1,638, and \$1,585, respectively, during 2020, 2019, and 2018, for shares of our Common stock purchased under the ESPP. At December 31, 2020, 457,408 shares remained available for purchase under the ESPP.

401(k) Plan

We have a profit sharing retirement plan for our employees that is qualified under Section 401(k) of the Internal Revenue Code. Annual matching contributions are made based on a percentage of eligible employee compensation deferrals. The contribution has historically been made with the issuance of Common stock to the plan on behalf of our employees. For the years ended December 31, 2020, 2019, and 2018, we issued 25,216, 30,715, and 17,318 shares of Common stock, respectively, to the plan, representing the Common stock discretionary matching contribution of \$4,543, \$4,274 and \$2,945, respectively.

11. PURCHASE OF REMAINING OWNERSHIP INTEREST IN JOINT VENTURE

Effective May 31, 2019, we purchased an additional 20% ownership interest in Homans Associates II LLC (“Homans”) from our second joint venture with Carrier, Carrier Enterprise Northeast, LLC, which we refer to as Carrier Enterprise II, for cash consideration of \$32,400, which increased our ownership in Homans to 100%. Homans previously operated as a division of Carrier Enterprise II and subsequent to the purchase operates as a wholly owned subsidiary of the Company with 17 locations in the Northeastern U.S.

12. INVESTMENT IN UNCONSOLIDATED ENTITY

On June 21, 2017, our first joint venture with Carrier, Carrier Enterprise, LLC, which we refer to as Carrier Enterprise I, acquired a 34.9% ownership interest in Russell Sigler, Inc. (“RSI”), an HVAC distributor operating from 30 locations in the Western U.S. We have an 80% controlling interest in Carrier Enterprise I, and Carrier has a 20% non-controlling interest. Carrier Enterprise I acquired its ownership interest in RSI for cash consideration of \$63,600, of which we contributed \$50,880 and Carrier contributed \$12,720. Effective June 29, 2018, Carrier Enterprise I acquired an additional 1.4% ownership interest in RSI, which increased Carrier Enterprise I’s ownership interest in RSI to 36.3% for cash consideration of \$3,760, of which we contributed \$3,008 and Carrier contributed \$752. Effective April 22, 2019, Carrier Enterprise I acquired an additional 1.8% ownership interest in RSI for cash consideration of \$4,940, of which we contributed \$3,952 and Carrier contributed \$988. This acquisition increased Carrier Enterprise I’s ownership interest in RSI to 38.1%.

Carrier Enterprise I is a party to a shareholders’ agreement (the “Shareholders’ Agreement”) with RSI and its shareholders. Pursuant to the Shareholders’ Agreement, RSI’s shareholders have the right to sell, and Carrier Enterprise I has the obligation to purchase, their respective shares of RSI for a purchase price determined based on either book value or a multiple of EBIT, the latter of which Carrier Enterprise I used to calculate the price paid for its investment in RSI. RSI’s shareholders may transfer their respective shares of RSI common stock only to members of the Sigler family or to Carrier Enterprise I, and, at any time from and after the date on which Carrier Enterprise I owns 85% or more of RSI’s outstanding common stock, it has the right, but not the obligation, to purchase from RSI’s shareholders the remaining outstanding shares of RSI common stock. Additionally, Carrier Enterprise I has the right to appoint two of RSI’s six board members. Given Carrier Enterprise I’s 38.1% equity interest in RSI and its right to appoint two out of RSI’s six board members, this investment in RSI is accounted for under the equity method.

13. ACQUISITIONS

N&S Supply of Fishkill, Inc.

On November 26, 2019, one of our wholly owned subsidiaries acquired certain assets and assumed certain liabilities of N&S Supply of Fishkill, Inc., a distributor of air conditioning, heating and plumbing products operating from seven locations in New York and Connecticut. The purchase price was composed of cash consideration of \$12,000, the issuance of 22,435 shares of Common stock having a fair value of \$3,871, net of a discount for lack of marketability, and the repayment of certain indebtedness. The purchase price resulted in the recognition of \$4,672 in goodwill and intangibles. The fair value of the identified intangible assets was \$1,540 and consisted of \$770 trade names and distribution rights, and \$770 in customer relationships to be amortized over an 18-year period. The tax basis of such goodwill is deductible for income tax purposes over 15 years.

Peirce-Phelps, Inc.

On August 1, 2019, Carrier Enterprise I acquired substantially all the HVAC assets and assumed certain of the liabilities of Peirce-Phelps, Inc. (“PPI”), an HVAC distributor operating from 19 locations in Pennsylvania, New Jersey, and Delaware, for \$85,000 less certain average revolving indebtedness. Consideration for the net purchase price consisted of \$10,000 in cash, 372,543 shares of Common stock having a fair value of \$58,344, net of a discount for lack of marketability, and the repayment of certain average revolving indebtedness. Carrier contributed cash of \$17,000 to Carrier Enterprise I in connection with the acquisition of PPI.

The purchase price resulted in the recognition of \$28,884 in goodwill and intangibles. The fair value of the identified intangible assets was \$19,000 and consisted of \$13,500 in trade names and distribution rights, and \$5,500 in customer relationships to be amortized over an 18-year period. The tax basis of such goodwill is deductible for income tax purposes over 15 years.

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The table below presents the allocation of the total consideration to tangible and intangible assets acquired and liabilities assumed from the acquisition of PPI based on the respective fair values as of August 1, 2019:

Cash and cash equivalents	\$ 4,299
Accounts receivable	30,719
Inventories	45,491
Other current assets	135
Property and equipment	2,544
Operating lease ROU assets	19,072
Goodwill	9,884
Intangibles	19,000
Other assets	299
Accounts payable	(11,079)
Accrued expenses and other current liabilities	(13,038)
Operating lease liabilities, net of current portion	(14,100)
Total	<u>\$ 93,226</u>

Dunphey & Associates Supply Co., Inc.

On April 2, 2019, one of our wholly owned subsidiaries acquired certain assets and assumed certain liabilities of Dunphey & Associates Supply Co., Inc., a distributor of air conditioning and heating products operating from seven locations in New Jersey, New York and Connecticut, for cash consideration of \$16,758 and the issuance of 50,952 shares of Common stock having a fair value of \$6,891, net of a discount for lack of marketability. The purchase price resulted in the recognition of \$8,974 in goodwill and intangibles. The fair value of the identified intangible assets was \$5,300 and consisted of \$2,500 trade names and trademarks, and \$2,800 in customer relationships to be amortized over a 15-year period. The tax basis of such goodwill is deductible for income tax purposes over 15 years.

Other Acquisitions

On August 23, 2018, one of our wholly owned subsidiaries acquired Alert Labs, Inc., a technology company based in Ontario, Canada for cash consideration of \$5,889 and the issuance of 23,873 shares of Common stock having a fair value of \$3,991, net of a discount for lack of marketability, less \$171 related to our previously held equity interest. In addition, 23,230 shares of Common stock having a fair value of \$3,026 were issued into escrow as contingent consideration, all of which are subject to certain performance metrics within a three-year measurement period. The purchase price resulted in the recognition of \$15,403 in goodwill and intangibles. The fair value of the identified intangible assets was \$1,640 and consisted of \$1,600 in patented and unpatented technologies and \$40 in customer relationships to be amortized over a seven-year period. The tax basis of the acquired goodwill recognized is not deductible for income tax purposes.

On November 30, 2018, 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 three locations in North Carolina.

The results of operations of these acquisitions have been included in the consolidated financial statements from their respective dates of acquisition. The pro forma effect of the acquisitions was not deemed significant to the consolidated financial statements.

14. GOODWILL AND INTANGIBLE ASSETS

The changes in the carrying amount of goodwill are as follows:

Balance at December 31, 2018	\$391,998
Acquired goodwill	16,742
Foreign currency translation adjustment	2,477
Balance at December 31, 2019	411,217
Acquired goodwill	410
Foreign currency translation adjustment	859
Balance at December 31, 2020	<u>\$412,486</u>

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Intangible assets are comprised of the following:

<u>December 31,</u>	<u>Estimated Useful Lives</u>	<u>2020</u>	<u>2019</u>
Indefinite lived intangible assets - Trade names, trademarks, and distribution rights		\$ 140,867	\$ 138,647
Finite lived intangible assets:			
Customer relationships	7-18 years	81,527	79,911
Patented and unpatented technology	7 years	1,714	1,680
Trade name	10 years	1,150	1,150
Accumulated amortization		(55,329)	(49,384)
Finite lived intangible assets, net		29,062	33,357
		<u>\$ 169,929</u>	<u>\$ 172,004</u>

Amortization expense related to finite lived intangible assets included in selling, general and administrative expenses for the years ended December 31, 2020, 2019, and 2018, were \$5,945, \$5,704, and \$5,348, respectively.

Annual amortization of finite lived intangible assets for the next five years is expected to approximate the following:

2021	\$ 5,100
2022	\$ 4,300
2023	\$ 3,700
2024	\$ 3,500
2025	\$ 3,400

15. SHAREHOLDERS' EQUITY

Common Stock

Common stock and Class B common stock share equally in earnings and are identical in most other respects except (i) Common stock is entitled to one vote on most matters and each share of Class B common stock is entitled to ten votes; (ii) shareholders of Common stock are entitled to elect 25% of the Board of Directors (rounded up to the nearest whole number) and Class B shareholders are entitled to elect the balance of the Board of Directors; (iii) cash dividends may be paid on Common stock without paying a cash dividend on Class B common stock and no cash dividend may be paid on Class B common stock unless at least an equal cash dividend is paid on Common stock and (iv) Class B common stock is convertible at any time into Common stock on a one-for-one basis at the option of the shareholder.

Preferred Stock

We are authorized to issue preferred stock with such designation, rights and preferences as may be determined from time to time by our Board of Directors. Accordingly, the Board of Directors is empowered, without shareholder approval, to issue preferred stock with dividend, liquidation, conversion, voting or other rights which could adversely affect the voting power or other rights of the holders of our Common stock and Class B common stock and, in certain instances, could adversely affect the market price of this stock. We had no preferred stock outstanding at December 31, 2020 or 2019.

Stock Repurchase Plan

In September 1999, our Board of Directors authorized the repurchase, at management's discretion, of up to 7,500,000 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. No shares were repurchased during 2020, 2019 or 2018. We last repurchased shares under this plan during 2008. In aggregate, 6,322,650 shares of Common stock and 48,263 shares of Class B common stock have been repurchased at a cost of \$114,425 since the inception of the program. At December 31, 2020, there were 1,129,087 shares remaining authorized for repurchase under the program.

16. FINANCIAL INSTRUMENTS

Recorded Financial Instruments

Recorded financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, the current portion of long-term obligations and borrowings under our revolving credit agreement. At December 31, 2020 and 2019, the fair values of cash and cash equivalents, accounts receivable, accounts payable and the current portion of long-term obligations approximated their carrying values due to the short-term nature of these instruments.

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The fair values of variable rate borrowings under our revolving credit agreement also approximate their carrying value based upon interest rates available for similar instruments with consistent terms and remaining maturities.

Off-Balance Sheet Financial Instruments

At December 31, 2020 and 2019, we were contingently liable under a standby letter of credit for \$1,075 and \$925, respectively, which was required by a lease for real property. Additionally, at December 31, 2020 and 2019, we were contingently liable under various performance bonds aggregating approximately \$11,400 and \$10,500, respectively, which are used as collateral to cover any contingencies related to our nonperformance under agreements with certain customers. We do not expect that any material losses or obligations will result from the issuance of the standby letter of credit or performance bonds because we expect to meet our obligations under our lease for real property and to certain customers in the ordinary course of business. Accordingly, the estimated fair value of these instruments is zero.

Concentrations of Credit Risk

Financial instruments which potentially subject us to concentrations of credit risk consist principally of accounts receivable. Concentrations of credit risk are limited due to the large number of customers comprising the customer base and their dispersion across many different geographical regions. We also have access to credit insurance programs which are used as an additional means to mitigate credit risk.

17. DERIVATIVES

We enter into foreign currency forward and option contracts to offset the earnings impact that foreign exchange rate fluctuations would otherwise have on certain monetary liabilities that are denominated in nonfunctional currencies.

Cash Flow Hedging Instruments

We enter into foreign currency forward contracts that are designated as cash flow hedges. The settlement of these derivatives results in reclassifications from accumulated other comprehensive loss to earnings for the period in which the settlement of these instruments occurs. The maximum period for which we hedge our cash flow using these instruments is 12 months. Accordingly, at December 31, 2020, all of our open foreign currency forward contracts had maturities of one year or less. We had only one foreign currency exchange contract designated as a cash flow hedge at December 31, 2020, the total notional value of which was \$1,000, and such contract subsequently expired during January 2021.

The impact from foreign exchange derivative instruments designated as cash flow hedges was as follows:

<i>Years Ended December 31,</i>	<u>2020</u>	<u>2019</u>
Gain (loss) recorded in accumulated other comprehensive loss	\$1,205	\$(2,001)
Gain reclassified from accumulated other comprehensive loss into earnings	\$ (574)	\$ (482)

At December 31, 2020, we expected an estimated \$402 pre-tax loss to be reclassified into earnings to reflect the fixed prices obtained from foreign exchange hedging within the next 12 months.

Derivatives Not Designated as Hedging Instruments

We have also entered into foreign currency forward and option contracts that are either not designated as hedges or did not qualify for hedge accounting. These derivative instruments were effective economic hedges for all of the periods presented. The fair value gains and losses on these contracts are recognized in earnings as a component of selling, general and administrative expenses. We had only one foreign currency exchange contract not designated as a hedging instrument at December 31, 2020, the total notional value of which was \$4,600, and such contract subsequently expired during January 2021.

We recognized (losses) gains of \$(490), \$(540), and \$129 from foreign currency forward and option contracts not designated as hedging instruments in our consolidated statements of income for 2020, 2019, and 2018, respectively.

The following table summarizes the fair value of derivative instruments, which consist solely of foreign exchange contracts, included in accrued expenses and other current liabilities in our consolidated balance sheets. See Note 18.

<i>December 31,</i>	<u>Asset Derivatives</u>		<u>Liability Derivatives</u>	
	<u>2020</u>	<u>2019</u>	<u>2020</u>	<u>2019</u>
Derivatives designated as hedging instruments	\$ —	\$ —	\$ 91	\$ 944
Derivatives not designated as hedging instruments	—	—	10	63
Total derivative instruments	\$ —	\$ —	\$ 101	\$ 1,007

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18. FAIR VALUE MEASUREMENTS

The following tables present our assets and liabilities carried at fair value that are measured on a recurring basis:

	Balance Sheet Location	Total	Fair Value Measurements at December 31, 2020 Using		
			Level 1	Level 2	Level 3
Assets:					
Equity securities	Other assets	\$6,065	\$6,065	—	—
Liabilities:					
Derivative financial instruments	Accrued expenses and other current liabilities	\$ 101	—	\$ 101	—

	Balance Sheet Location	Total	Fair Value Measurements at December 31, 2019 Using		
			Level 1	Level 2	Level 3
Assets:					
Equity securities	Other assets	\$ 402	\$ 402	—	—
Private equities	Other assets	\$2,500	—	—	\$2,500
Liabilities:					
Derivative financial instruments	Accrued expenses and other current liabilities	\$1,007	—	\$1,007	—

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:

Equity securities – these investments are exchange-traded equity securities. Fair values for these investments are based on closing stock prices from active markets and are therefore classified within Level 1 of the fair value hierarchy.

Derivative financial instruments – these derivatives are foreign currency forward and option contracts. See Note 17. Fair value is based on observable market inputs, such as forward rates in active markets; therefore, we classify these derivatives within Level 2 of the valuation hierarchy.

Private equities – investment in Porch.com, Inc. Fair value was based on cost as of December 23, 2019 as inputs for the asset were unobservable, therefore, we classified this investment within Level 3 of the fair value hierarchy at December 31, 2019. The company went public on December 23, 2020 and accordingly, the fair value was based on the closing stock price from active markets and therefore was transferred to Level 1 of the fair value hierarchy at December 31, 2020.

19. 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 and 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 adverse effect on 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. Reserves in the amounts of \$5,404 and \$3,062 at December 31, 2020 and 2019, respectively, were established related to such programs and are included in accrued expenses and other current liabilities in our consolidated balance sheets.

Variable Interest Entity

As of December 31, 2020, in conjunction with our casualty insurance programs, limited equity interests are held in a captive insurance entity. The programs permit us to self-insure a portion of losses, to gain access to a wide array of safety-related services, to pool insurance risks and resources in order to obtain more competitive pricing for administration and reinsurance and to limit risk of loss in any particular year. The entity meets the definition of Variable Interest Entity (“VIE”); however, we do not meet the requirements to include this entity in the consolidated financial statements. The maximum exposure to loss related to our involvement with this entity is limited to approximately \$3,600. At December 31, 2020, we have a cash deposit of \$2,400 with the captive insurance entity as collateral to cover any contingency related to additional risk assessments pertaining to our self-insurance programs. See “Self-Insurance” above for further information on commitments associated with the insurance programs. At December 31, 2020, there were no other entities that met the definition of a VIE.

Purchase Obligations

At December 31, 2020, we were obligated under various non-cancelable purchase orders with our key suppliers for goods aggregating approximately \$32,000, of which approximately \$13,000 is with Carrier and its affiliates.

20. RELATED PARTY TRANSACTIONS

Purchases from Carrier and its affiliates comprised 63%, 62%, and 62% of all inventory purchases made during 2020, 2019 and 2018, respectively. At December 31, 2020 and 2019, approximately \$81,000 and \$86,000, respectively, was payable to Carrier and its affiliates, net of receivables. Our joint ventures with Carrier also sell HVAC products to Carrier and its affiliates. Revenues in our consolidated statements of income for 2020, 2019, and 2018 included approximately \$103,000, \$91,000, and \$84,000, respectively, of sales to Carrier and its affiliates. We believe these transactions are conducted on terms equivalent to an arm’s-length basis in the ordinary course of business.

A member of our Board of Directors is the Senior Chairman of Greenberg Traurig, P.A., which serves as our principal outside counsel for compliance and acquisition-related legal services. During 2020, 2019, and 2018, fees for services performed were \$156, \$187, and \$131, respectively, and \$8 was payable at December 31, 2020.

A member of our Board of Directors is the Chairman and Chief Executive Officer of Moss & Associates LLC, which served as general contractor for the remodeling of our Miami headquarters that was completed in 2018. We paid Moss & Associates LLC \$124 for construction services performed during 2018.

21. INFORMATION ABOUT GEOGRAPHIC AREAS

Our operations are primarily within the United States, including Puerto Rico, Canada and Mexico. Products are also sold from the United States on an export-only basis to portions of Latin America and the Caribbean Basin. The following tables set forth revenues and long-lived assets by geographical area:

<i>Years Ended December 31,</i>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Revenues:			
United States	\$ 4,535,262	\$ 4,184,206	\$ 3,981,056
Canada	301,727	294,040	291,685
Latin America and the Caribbean	217,939	292,116	273,912
Total revenues	<u>\$ 5,054,928</u>	<u>\$ 4,770,362</u>	<u>\$ 4,546,653</u>

<i>December 31,</i>	<u>2020</u>	<u>2019</u>
Long-Lived Assets:		
United States	\$ 799,665	\$ 808,685
Canada	180,518	180,663
Latin America and the Caribbean	19,719	20,083
Total long-lived assets	<u>\$ 999,902</u>	<u>\$ 1,009,431</u>

Revenues are attributed to countries based on the location of the store from which the sale occurred. Long-lived assets consist primarily of goodwill and intangible assets, operating lease ROU assets, property and equipment, and our investment in an unconsolidated entity.

22. SUPPLEMENTAL CASH FLOW INFORMATION

Supplemental cash flow information was as follows:

<i>Years Ended December 31,</i>	<u>2020</u>	<u>2019</u>	<u>2018</u>
Interest paid	\$ 1,844	\$ 4,341	\$ 3,065
Income taxes net of refunds	\$70,889	\$70,095	\$115,301
Common stock issued for N&S Supply of Fishkill, Inc.	\$ (161)	\$ 4,032	—
Common stock issued for Peirce-Phelps, Inc.	—	\$58,344	—
Common stock issued for Dunphey & Associates Supply Co., Inc.	—	\$ 6,891	—
Common stock issued for Alert Labs, Inc.	—	—	\$ 6,846

23. SUBSEQUENT EVENT

On February 9, 2021, our Board of Directors approved an increase to the quarterly cash dividend per share of Common and Class B common stock to \$1.95 per share from \$1.775 per share, beginning with the dividend that will be paid in April 2021.

WATSCO, INC. AND SUBSIDIARIES
SELECTED QUARTERLY FINANCIAL DATA
(UNAUDITED)

<i>(In thousands, except per share data)</i>	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	Total
Year Ended December 31, 2020					
Revenues (1)	\$ 1,008,156	\$ 1,355,385	\$ 1,536,671	\$ 1,154,716	\$ 5,054,928
Gross profit	\$ 247,615	\$ 319,199	\$ 373,763	\$ 282,244	\$ 1,222,821
Net income attributable to Watsco, Inc.	\$ 30,502	\$ 86,578	\$ 106,489	\$ 46,010	\$ 269,579
Earnings per share for Common and Class B common stock (2):					
Basic	\$ 0.72	\$ 2.26	\$ 2.77	\$ 1.14	\$ 7.03
Diluted	\$ 0.72	\$ 2.26	\$ 2.76	\$ 1.14	\$ 7.01
Year Ended December 31, 2019					
Revenues (1)	\$ 931,278	\$ 1,371,854	\$ 1,394,915	\$ 1,072,315	\$ 4,770,362
Gross profit	\$ 233,760	\$ 327,984	\$ 334,691	\$ 260,521	\$ 1,156,956
Net income attributable to Watsco, Inc.	\$ 35,037	\$ 90,155	\$ 83,480	\$ 37,278	\$ 245,950
Earnings per share for Common and Class B common stock (2):					
Basic	\$ 0.88	\$ 2.40	\$ 2.20	\$ 0.92	\$ 6.51
Diluted	\$ 0.88	\$ 2.40	\$ 2.20	\$ 0.92	\$ 6.50

- (1) *Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the first and fourth quarters. Demand related to the new construction sectors throughout most of the markets is fairly evenly distributed throughout the year except for dependence on housing completions and related weather and economic conditions.*
- (2) *Quarterly and year-to-date earnings per share are calculated on an individual basis; therefore, the sum of earnings per share amounts for the quarters may not equal earnings per share amounts for the year.*

SUBSIDIARIES OF THE REGISTRANT

The following table sets forth the significant subsidiaries of Watsco, Inc. as of December 31, 2020, and their respective incorporation jurisdictions. The names of various other wholly owned subsidiaries have been omitted. None of the foregoing omitted subsidiaries, considered either alone or in the aggregate as a single subsidiary, constitutes a significant subsidiary.

<u>Name of Subsidiary</u>	<u>State or Other Jurisdiction of Incorporation</u>	<u>Percent of Ownership</u>
Alert Labs, Inc.	Ontario, Canada	100%
Baker Distributing Company LLC	Delaware	100%
Boreal International Corporation	Florida	100%
Carrier Enterprise Canada, L.P.	Ontario, Canada	60%
Carrier Enterprise Mexico S. de R.L. de C.V.	Mexico	80%
Carrier Enterprise, LLC	Delaware	80%
Carrier Enterprise Northeast, LLC	Delaware	80%
Carrier InterAmerica Corporation	Delaware	80%
Carrier (Puerto Rico), Inc.	Delaware	80%
East Coast Metal Distributors LLC	Delaware	100%
Gemaire Distributors LLC	Delaware	100%
Heating & Cooling Supply LLC	California	100%
Homans Associates II LLC	Delaware	100%
N&S Supply LLC	Delaware	100%
Peirce-Phelps LLC	Delaware	80%
Tradewinds Distributing Company, LLC	Delaware	100%

Consent of Independent Registered Public Accounting Firm

The Board of Directors
Watsco, Inc.:

We consent to the incorporation by reference in the registration statement (No. 333-228269) on Form S-3 and (No. 333-197795, 333-185345, and 333-159776) on Form S-8 of Watsco, Inc. of our reports dated February 26, 2021, with respect to the consolidated balance sheets of Watsco, Inc. and subsidiaries (the Company) as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2020, and the related notes and the effectiveness of internal control over financial reporting as of December 31, 2020, which reports appear in the December 31, 2020 annual report on Form 10-K of the Company.

Our report on the consolidated financial statements refers to a change in the Company's method of accounting for leases as of January 1, 2019, due to the adoption of Accounting Standards Update No. 2016-02, Leases (Topic 842), as amended.

/s/ KPMG LLP

Miami, Florida
February 26, 2021

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Albert H. Nahmad, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 26, 2021

/s/ Albert H. Nahmad

Albert H. Nahmad
Chief Executive Officer

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Barry S. Logan, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 26, 2021

/s/ Barry S. Logan

Barry S. Logan
Executive Vice President

CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002

I, Ana M. Menendez, certify that:

1. I have reviewed this Annual Report on Form 10-K of Watsco, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of this annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 26, 2021

/s/ Ana M. Menendez

Ana M. Menendez
Chief Financial Officer

CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Annual Report of Watsco, Inc. ("Watsco") on Form 10-K for the year ended December 31, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Albert H. Nahmad, as Chief Executive Officer of Watsco, Barry S. Logan, as Executive Vice President of Watsco and Ana M. Menendez, as Chief Financial Officer of Watsco, each hereby certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to our knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Watsco.

/s/ Albert H. Nahmad

Albert H. Nahmad
Chief Executive Officer
February 26, 2021

/s/ Barry S. Logan

Barry S. Logan
Executive Vice President
February 26, 2021

/s/ Ana M. Menendez

Ana M. Menendez
Chief Financial Officer
February 26, 2021

A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to Watsco and will be retained by Watsco and furnished to the Securities and Exchange Commission or its staff upon request.

This certification accompanies the Report pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by Watsco for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.