

COMFORT SYSTEMS USA INC

Form 10-Q

April 25, 2019

false--12-31Q120192019-03-3110-Q0001035983YesfalseLarge Accelerated FilerCOMFORT SYSTEMS USA  
INCfalseP1Y00trueP3YP10Y26150000us-gaap:OtherLiabilitiesCurrent7590000000001035983fix:StockRepurchaseProgram2

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

(Mark  
One)

**QUARTERLY REPORT PURSUANT TO SECTION 13, OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**For the quarterly period ended March 31, 2019**

**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: 1-13011**

**COMFORT SYSTEMS USA, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

**76-0526487**

(State or other jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)

**675 Bering Drive**

**Suite 400**

**Houston, Texas 77057**

(Address of Principal Executive Offices) (Zip  
Code)

Registrant's telephone number, including area code: **(713) 830-9600**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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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 (Section 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	Accelerated filer	Non-accelerated filer	Smaller reporting company	Emerging growth company
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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 is a shell company (as defined in Exchange Act Rule 12b-2). Yes No

The number of shares outstanding of the issuer’s common stock as of April 22, 2019 was 36,904,514 (excluding treasury shares of 4,218,851).

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**COMFORT SYSTEMS USA, INC.**

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Table of Contents**PART I—FINANCIAL INFORMATION****Item 1. Financial Statements****COMFORT SYSTEMS USA, INC.****CONSOLIDATED BALANCE SHEETS****(In Thousands, Except Share Amounts)**

	<b>March 31, 2019 (Unaudited)</b>	<b>December 31, 2018</b>
<b>ASSETS</b>		
<b>CURRENT ASSETS:</b>		
Cash and cash equivalents	\$ 29,130	\$ 45,620
Billed accounts receivable, less allowance for doubtful accounts of \$5,865 and \$5,898, respectively	447,298	481,366
Unbilled accounts receivable	38,463	37,180
Other receivables	13,711	16,361
Inventories	12,908	12,416
Prepaid expenses and other	7,476	6,544
Costs and estimated earnings in excess of billings	8,286	10,213
Total current assets	557,272	609,700
<b>PROPERTY AND EQUIPMENT, NET</b>	<b>102,774</b>	<b>99,618</b>
<b>LEASE RIGHT-OF-USE ASSET</b>	<b>70,316</b>	<b>—</b>
<b>GOODWILL</b>	<b>235,860</b>	<b>235,182</b>
<b>IDENTIFIABLE INTANGIBLE ASSETS, NET</b>	<b>91,073</b>	<b>95,275</b>
<b>DEFERRED TAX ASSETS</b>	<b>17,485</b>	<b>17,634</b>
<b>OTHER NONCURRENT ASSETS</b>	<b>5,252</b>	<b>5,155</b>
Total assets	\$ 1,080,032	\$ 1,062,564
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>CURRENT LIABILITIES:</b>		
Current maturities of long-term debt	\$ 2,755	\$ 3,279
Accounts payable	136,115	176,167
Accrued compensation and benefits	65,135	87,388
Billings in excess of costs and estimated earnings	120,290	130,986
Accrued self-insurance	37,615	36,386
Other current liabilities	47,933	32,852

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Total current liabilities	409,843	467,058
LONG-TERM DEBT	74,483	73,639
LONG-TERM LEASE LIABILITIES	62,028	—
DEFERRED TAX LIABILITIES	1,387	1,387
OTHER LONG-TERM LIABILITIES	17,096	22,433
Total liabilities	564,837	564,517
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding	—	—
Common stock, \$.01 par, 102,969,912 shares authorized, 41,123,365 and 41,123,365 shares issued, respectively	411	411
Treasury stock, at cost, 4,232,418 and 4,229,653 shares, respectively	(90,171)	(87,747)
Additional paid-in capital	319,691	316,479
Retained earnings	285,264	268,904
Total stockholders' equity	515,195	498,047
Total liabilities and stockholders' equity	\$ 1,080,032	\$ 1,062,564

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**COMFORT SYSTEMS USA, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In Thousands, Except Per Share Data)****(Unaudited)**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2019</b>	<b>2018</b>
REVENUE	\$ 538,473	\$ 464,941
COST OF SERVICES	431,808	375,888
Gross profit	106,665	89,053
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	78,905	70,023
GAIN ON SALE OF ASSETS	(219)	(211)
Operating income	27,979	19,241
OTHER INCOME (EXPENSE):		
Interest income	25	14
Interest expense	(1,062)	(713)
Changes in the fair value of contingent earn-out obligations	(158)	153
Other	15	38
Other income (expense)	(1,180)	(508)
INCOME BEFORE INCOME TAXES	26,799	18,733
PROVISION FOR INCOME TAXES	6,933	2,074
NET INCOME	\$ 19,866	\$ 16,659
INCOME PER SHARE:		
Basic	\$ 0.54	\$ 0.45
Diluted	\$ 0.53	\$ 0.44
SHARES USED IN COMPUTING INCOME PER SHARE:		
Basic	36,923	37,192
Diluted	37,234	37,628
DIVIDENDS PER SHARE	\$ 0.095	\$ 0.075

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**COMFORT SYSTEMS USA, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****(In Thousands, Except Share Amounts)**

	<b>Three Months Ended March 31, 2018</b>				<b>Additional Paid-In Capital</b>	<b>Retained Earnings</b>	<b>Total Stockholders' Equity</b>
	<b>Common Stock Shares</b>	<b>Amount</b>	<b>Treasury Stock Shares</b>	<b>Amount</b>			
BALANCE AT DECEMBER 31, 2017	41,123,365	\$ 411	(3,936,291)	\$ (63,519)	\$ 312,784	\$ 168,269	\$ 417,945
Net income (unaudited)	—	—	—	—	—	16,659	16,659
Issuance of Stock:							
Issuance of shares for options exercised (unaudited)	—	—	19,124	326	(88)	—	238
Issuance of restricted stock & performance stock (unaudited)	—	—	52,306	892	1,331	—	2,223
Shares received in lieu of tax withholding payment on vested restricted stock (unaudited)	—	—	(19,921)	(846)	—	—	(846)
Stock-based compensation (unaudited)	—	—	—	—	1,880	—	1,880
Dividends (unaudited)	—	—	—	—	—	(2,786)	(2,786)
	—	—	(150,481)	(6,175)	—	—	(6,175)

Share  
repurchase  
(unaudited)  
BALANCE  
AT MARCH  
31, 2018  
(unaudited)

41,123,365	\$ 411	(4,035,263)	\$ (69,322)	\$ 315,907	\$ 182,142	\$ 429,138
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**Three Months Ended  
March 31, 2019**

	<b>Common Stock</b>		<b>Treasury Stock</b>		<b>Additional</b>	<b>Retained</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>	<b>Paid-In Capital</b>	<b>Earnings</b>	<b>Stockholders' Equity</b>
BALANCE AT DECEMBER 31, 2018	41,123,365	\$ 411	(4,229,653)	\$ (87,747)	\$ 316,479	\$ 268,904	\$ 498,047
Net income (unaudited)	—	—	—	—	—	19,866	19,866
Issuance of Stock:							
Issuance of shares for options exercised (unaudited)	—	—	41,103	861	(61)	—	800
Issuance of restricted stock & performance stock (unaudited)	—	—	38,539	817	1,189	—	2,006
Shares received in lieu of tax withholding payment on vested restricted stock (unaudited)	—	—	(15,013)	(781)	—	—	(781)
Stock-based compensation (unaudited)	—	—	—	—	2,084	—	2,084
Dividends (unaudited)	—	—	—	—	—	(3,506)	(3,506)
	—	—	(67,394)	(3,321)	—	—	(3,321)



Share  
repurchase  
(unaudited)

BALANCE

AT MARCH

31, 2019

41,123,365	\$ 411	(4,232,418)	\$ (90,171)	\$ 319,691	\$ 285,264	\$ 515,195
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(unaudited)

The accompanying notes are an integral part of these consolidated financial statements.

Table of Contents**COMFORT SYSTEMS USA, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In Thousands)****(Unaudited)**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2019</b>	<b>2018</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 19,866	\$ 16,659
Adjustments to reconcile net income to net cash provided by operating activities—		
Amortization of identifiable intangible assets	4,891	3,827
Depreciation expense	5,833	5,413
Bad debt expense	235	261
Deferred tax provision	149	8,648
Amortization of debt financing costs	96	94
Gain on sale of assets	(219)	(211)
Changes in the fair value of contingent earn-out obligations	158	(153)
Stock-based compensation	3,176	2,793
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures—		
(Increase) decrease in—		
Receivables, net	38,272	(3,542)
Inventories	(492)	(537)
Prepaid expenses and other current assets	(2,083)	3,388
Costs and estimated earnings in excess of billings and unbilled accounts receivable	671	(8,065)
Other noncurrent assets	3,061	296
Increase (decrease) in—		
Accounts payable and accrued liabilities	(59,331)	(15,663)
Billings in excess of costs and estimated earnings	(10,740)	(293)
Other long-term liabilities	(2,552)	(9,064)
Net cash provided by operating activities	991	3,851
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(8,844)	(5,588)
Proceeds from sales of property and equipment	357	366
Cash paid for acquisitions, net of cash acquired	(1,313)	(6,719)
Net cash used in investing activities	(9,800)	(11,941)

CASH FLOWS FROM FINANCING ACTIVITIES:

Proceeds from revolving line of credit	54,000	20,000
Payments on revolving line of credit	(53,000)	(15,000)
Payments on other debt	(1,030)	(546)
Payments of dividends to stockholders	(3,506)	(2,786)
Share repurchase	(3,321)	(4,293)
Shares received in lieu of tax withholding	(781)	(846)
Proceeds from exercise of options	800	238
Deferred acquisition payments	(250)	—
Payments for contingent consideration arrangements	(593)	—
Net cash used in financing activities	(7,681)	(3,233)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(16,490)	(11,323)
CASH AND CASH EQUIVALENTS, beginning of period	45,620	36,542
CASH AND CASH EQUIVALENTS, end of period	\$ 29,130	\$ 25,219

The accompanying notes are an integral part of these consolidated financial statements.

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**COMFORT SYSTEMS USA, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**March 31, 2019**

**(Unaudited)**

**1. Business and Organization**

Comfort Systems USA, Inc., a Delaware corporation, provides comprehensive mechanical contracting services, which principally includes heating, ventilation and air conditioning (“HVAC”), plumbing, piping and controls, as well as off-site construction, electrical, monitoring and fire protection. We install, maintain, repair and replace products and systems throughout the United States. Approximately 41.6% of our consolidated 2019 revenue is attributable to installation of systems in newly constructed facilities, with the remaining 58.4% attributable to maintenance, repair and replacement services. The terms “Comfort Systems,” “we,” “us,” or the “Company,” refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

**2. Summary of Significant Accounting Policies**

***Basis of Presentation***

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) for the year ended December 31, 2018 (the “Form 10-K”).

The accompanying unaudited consolidated financial statements were prepared using generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X

of the SEC. Accordingly, these financial statements do not include all the footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the Form 10-K. We believe all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for interim periods are not necessarily indicative of the results for the full fiscal year.

### *Use of Estimates*

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions by management in determining the reported amounts of assets and liabilities, revenue and expenses and disclosures regarding contingent assets and liabilities. Actual results could differ from those estimates. The most significant estimates used in our financial statements affect revenue and cost recognition for construction contracts, the allowance for doubtful accounts, self-insurance accruals, deferred tax assets, warranty accruals, fair value accounting for acquisitions and the quantification of fair value for reporting units in connection with our goodwill impairment testing.

### *Recent Accounting Pronouncements*

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)". The standard requires substantially all leases (with the exception of leases with a term of one year or less) to be recorded on the balance sheet using a method referred to as the right-of-use asset approach. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018 and interim periods within those years. Full retrospective application is prohibited. We adopted ASU No. 2016-02, Leases (Topic 842), on January 1, 2019, using the transition method allowed by ASU No. 2018-11, "Leases (Topic 842) Targeted Improvements" in which lessees apply the new lease standard on the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. We adopted the practical expedient allowing us to not include leases with an initial term of 12 months or less on the balance sheet. Furthermore, we elected to apply the practical expedient allowing an entity to forgo reassessing (1) whether expired or existing contracts contain a lease, (2) classification of expired or existing leases, and (3) whether capitalized

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costs associated with expired or existing leases should be classified as “initial direct costs” under Topic 842. The adoption of ASU 2016-02 did not have a significant impact to our Statement of Operations or Cash Flows. The adoption of ASU 2016-02 resulted in the recording of right-of-use asset and lease liabilities of \$75.9 million on our Balance Sheet as of January 1, 2019 but did not result in a cumulative-effect adjustment to retained earnings.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326)”. The standard requires companies to consider historical experiences, current market conditions and reasonable and supportable forecasts in the measurement of expected credit losses. ASU 2016-13 is effective for fiscal years beginning after December 15, 2019 and interim periods within those years. Early adoption is permitted. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement”. This standard removes certain disclosure requirements including the valuation processes for Level 3 fair value measurements, the policy for timing of transfers between levels and the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy. The standard requires certain additional disclosures for public entities, including disclosure of the changes in unrealized gains and losses included in Other Comprehensive Income for Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. ASU 2018-13 is effective for fiscal years beginning after December 15, 2019 and interim periods within those years. Certain amendments, including the amendment on changes in unrealized gains and losses and the range and weighted average of significant unobservable inputs, should be applied prospectively while other amendments should be applied retrospectively to all periods presented upon their effective date. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

## ***Revenue Recognition***

Revenue is recognized when control of the promised goods or services is transferred to our customers, in an amount that reflects the consideration to which we expect to be entitled in exchange for those goods or services. Sales-based taxes are excluded from revenue.

We provide comprehensive mechanical contracting services, which principally includes HVAC, plumbing, piping and controls, as well as off-site construction, electrical, monitoring and fire protection. We install, maintain, repair and replace products and systems throughout the United States. All of our revenue is recognized over time as we deliver goods and services to our customers. Revenue can be earned based on an agreed upon fixed price or based on actual costs incurred marked up at an agreed upon percentage.

For fixed price agreements, we use the percentage of completion method of accounting under which contract revenue recognizable at any time during the life of a contract is determined by multiplying expected total contract revenue by the percentage of contract costs incurred at any time to total estimated contract costs. More specifically, as part of the negotiation and bidding process to obtain installation contracts, we estimate our contract costs, which include all direct materials, labor and subcontract costs and indirect costs related to contract performance, such as indirect labor, supplies, tools, repairs and depreciation costs. These contract costs are included in our results of operations under the caption "Cost of Services." Then, as we perform under those contracts, we measure costs incurred, compare them to total estimated costs to complete the contract and recognize a corresponding proportion of contract revenue. Labor costs are considered to be incurred as the work is performed. Subcontractor labor is recognized as the work is performed. Non-labor project costs consist of purchased equipment, prefabricated materials and other materials. Purchased equipment on our projects is substantially produced to job specifications and is a value-added element to our work. The costs are considered to be incurred when title is transferred to us, which typically is upon delivery to the work site. Prefabricated materials, such as ductwork and piping, are generally performed at our shops and recognized as contract costs when fabricated for the unique specifications of the job. Other materials costs are generally recorded when delivered to the work site. This measurement and comparison process requires updates to the estimate of total costs to complete the contract, and these updates may include subjective assessments and judgments.

We account for a contract when: (i) it has approval and commitment from both parties, (ii) the rights of the parties are identified, (iii) payment terms are identified, (iv) the contract has commercial substance, and (v) collectability

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of consideration is probable. We consider the start of a project to be when the above criteria have been met and we either have written authorization from the customer to proceed or an executed contract.

Selling, marketing and estimation costs incurred in relation to selling contracts are expensed as incurred. On rare occasions, we may incur significant expenses related to selling a contract that we only incurred because we sold that contract. If this occurs, we capitalize that cost and amortize it on a percentage of completion basis over the life of the contract. We do not currently have any capitalized selling, marketing, or estimation costs on our Balance Sheet and did not incur any impairment loss in the current year.

We generally do not incur significant incremental costs related to obtaining or fulfilling a contract prior to the start of a project. On rare occasions, when significant pre-contract costs are incurred, they are capitalized and amortized on a percentage of completion basis over the life of the contract. We do not currently have any capitalized obtaining or fulfillment costs on our Balance Sheet and did not incur any impairment loss on such costs in the current year.

Project contracts typically provide for a schedule of billings or invoices to the customer based on our job to date percentage of completion of specific tasks inherent in the fulfillment of our performance obligation(s). The schedules for such billings usually do not precisely match the schedule on which costs are incurred. As a result, contract revenue recognized in the statement of operations can and usually does differ from amounts that can be billed or invoiced to the customer at any point during the contract. Amounts by which cumulative contract revenue recognized on a contract as of a given date exceed cumulative billings and unbilled receivables to the customer under the contract are reflected as a current asset in our balance sheet under the caption "Costs and estimated earnings in excess of billings." Amounts by which cumulative billings to the customer under a contract as of a given date exceed cumulative contract revenue recognized on the contract are reflected as a current liability in our balance sheet under the caption "Billings in excess of costs and estimated earnings."

We typically invoice our customers with payment terms of net due in 30 days. It is common in the construction industry for a contract to specify more lenient payment terms allowing the customer 45 to 60 days to make their payment. It is also common for the contract in the construction industry to specify that a general contractor is not required to submit payments to a subcontractor until it has received those funds from the owner or funding source. In most instances we receive payment of our invoices between 30 to 90 days of the date of the invoice.

A performance obligation is a promise in a contract to transfer a distinct good or service to the customer and is the unit of account in ASC Topic 606. A contract's transaction price is allocated to each distinct performance obligation and recognized as revenue when, or as, the performance obligation is satisfied.

To determine the proper revenue recognition method for contracts, we evaluate whether two or more contracts should be combined and accounted for as one performance obligation and whether the combined or single contract should be accounted for as more than one performance obligation. This evaluation requires significant judgment and the decision to combine a group of contracts or separate the combined or single contract into multiple performance obligations could change the amount of revenue and profit recorded in a given period. For most of our contracts, the customer contracts with us to provide a significant service of integrating a complex set of tasks and components into a



single project or capability (even if that single project results in the delivery of multiple units). Hence, the entire contract is accounted for as one performance obligation. Less commonly, however, we may promise to provide distinct goods or services within a contract, in which case we separate the contract into more than one performance obligation. If a contract is separated into more than one performance obligation, we allocate the total transaction price to each performance obligation in an amount based on the estimated relative standalone selling prices of the promised goods or services underlying each performance obligation. We infrequently sell standard products with observable standalone sales. In cases where we do, the observable standalone sales are used to determine the standalone selling price. More frequently, we sell a customized customer specific solution, and in these cases we typically use the expected cost plus a margin approach to estimate the standalone selling price of each performance obligation.

We recognize revenue over time for all of our services as we perform them, because (i) control continuously transfers to that customer as work progresses, and (ii) we have the right to bill the customer as costs are incurred. The customer typically controls the work in process as evidenced either by contractual termination clauses or by our rights to

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payment for work performed to date plus a reasonable profit to deliver products or services that do not have an alternative use to the Company.

For the reasons listed above, revenue is recognized based on the extent of progress towards completion of the performance obligation. The selection of the method to measure progress towards completion requires judgment and is based on the nature of the products or services to be provided. We generally use the cost to cost measure of progress for our contracts as it best depicts the transfer of assets to the customer that occurs as we incur costs on our contracts. Under the cost to cost measure of progress, the extent of progress towards completion is measured based on the ratio of costs incurred to date to the total estimated costs at completion of the performance obligation. Revenue, including estimated fees or profits, is recorded proportionally as costs are incurred. Costs to fulfill include labor, materials and subcontractors' costs, other direct costs and an allocation of indirect costs.

For a small portion of our business in which our services are delivered in the form of service maintenance agreements for existing systems to be repaired and maintained, as opposed to constructed, our performance obligation is to maintain the customer's mechanical system for a specific period of time. Similar to jobs, we recognize revenue over time; however, for service maintenance agreements in which the full cost to provide services may not be known, we generally use an input method to recognize revenue, which is based on the amount of time we have provided our services out of the total time we have been contracted to perform those services.

Due to the nature of the work required to be performed on many of our performance obligations, the estimation of total revenue and cost at completion (the process described below in more detail) is complex, subject to many variables and requires significant judgment. The consideration to which we are entitled on our long-term contracts may include both fixed and variable amounts. Variable amounts can either increase or decrease the transaction price. A common example of variable amounts that can either increase or decrease contract value are pending change orders that represent contract modifications for which a change in scope has been authorized or acknowledged by our customer, but the final adjustment to contract price is yet to be negotiated. Other examples of positive variable revenue include amounts awarded upon achievement of certain performance metrics, program milestones or cost of completion date targets and can be based upon customer discretion. Variable amounts can result in a deduction from contract revenue if we fail to meet stated performance requirements, such as complying with the construction schedule.

Contracts are often modified to account for changes in contract specifications and requirements. We consider contract modifications to exist when the modification either creates new or changes the existing enforceable rights and obligations. Most of our contract modifications are for goods or services that are not distinct from the existing performance obligation(s). The effect of a contract modification on the transaction price, and our measure of progress for the performance obligation to which it relates, is recognized as an adjustment to revenue (either as an increase or decrease) on a cumulative catchup basis.

We have a Company-wide policy requiring periodic review of the Estimate at Completion in which management reviews the progress and execution of our performance obligations and estimated remaining obligations. As part of this process, management reviews information including, but not limited to, any outstanding key contract matters, progress towards completion and the related program schedule, identified risks and opportunities and the related changes in estimates of revenue and costs. The risks and opportunities include management's judgment about the ability and cost to achieve the schedule (e.g., the number and type of milestone events), technical requirements (e.g., a newly developed product versus a mature product) and other contract requirements. Management must make assumptions and estimates regarding labor productivity and availability, the complexity of the work to be performed, the availability of materials, the length of time to complete the performance obligation (e.g. to estimate increases in wages and prices for materials and related support cost allocations), execution by our subcontractors, the availability and timing of funding from our customer, and overhead cost rates, among other variables.

Based on this analysis, any adjustments to revenue, cost of services, and the related impact to operating income are recognized as necessary in the quarter they become known. These adjustments may result from positive program performance if we determine we will be successful in mitigating risks surrounding the technical, schedule and cost aspects of those performance obligations or realizing related opportunities and may result in an increase in operating income during the performance of individual performance obligations. Likewise, if we determine we will not be successful in mitigating these risks or realizing related opportunities these adjustments may result in a decrease in

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operating income. Changes in estimates of revenue, cost of services and the related impact to operating income are recognized quarterly on a cumulative catchup basis, which recognizes in the current period the cumulative effect of the changes on current and prior periods based on a performance obligation's percentage of completion. A significant change in one or more of these estimates could affect the profitability of one or more of our performance obligations. For projects where estimates of total costs to be incurred on a performance obligation exceed total estimates of revenue to be earned, a provision for the entire loss on the performance obligation is recognized in the period the loss is determined.

The Company typically does not incur any returns, refunds, or similar obligations after the completion of the performance obligation since any deficiencies are corrected during the course of the work or are included as a modification to revenue. The Company does offer an industry standard warranty on our work, which is most commonly for a one-year period. The vendors providing the equipment and materials are responsible for any failures in their product unless installed incorrectly. We include an estimated amount to cover estimated warranty expense in our Cost of Services and record a liability on our Balance Sheet to cover our current estimated outstanding warranty obligations.

Prior to implementing ASC 606 on January 1, 2018, our methods for recognizing revenue were very similar to our current method under ASC 606. We used the actual cost as a percent of total expected cost at completion to estimate our percentage complete on fixed price jobs, a mark-up of costs for jobs where revenue was based on time and materials incurred and elapsed time for those service maintenance contracts where the full cost to provide the services cannot be reasonably estimated. Furthermore, our process for allocating transaction price to performance obligations is also substantially similar to prior years where, in most cases, a contract is one performance obligation. In those cases where a contract is determined to have more than one performance obligation, the contract price is allocated to each performance obligation based on its standalone sales price.

In the first three months of 2018 and 2019, net revenue recognized from our performance obligations satisfied in previous periods was not material.

### ***Disaggregation of Revenue***

We disaggregate our revenue from contracts with customers by activity, customer type and contract type, as we believe it best depicts how the nature, amount, timing and uncertainty of our revenue and cash flows are affected by economic factors. Our consolidated 2019 revenue was derived from the following service activities, all of which are in the mechanical services industry, the single industry segment we serve. See details in the following tables (dollars in thousands):

<b>Revenue by Service Provided</b>	<b>Three Months Ended March 31,</b>					
	<b>2019</b>			<b>2018</b>		
HVAC and Plumbing	\$ 481,990	89.5	%	\$ 424,017	91.2	%
Building Automation Control Systems	29,014	5.4	%	20,045	4.3	%
Other	27,469	5.1	%	20,879	4.5	%
Total	\$ 538,473	100.0	%	\$ 464,941	100.0	%

<b>Revenue by Type of Customer</b>	<b>Three Months Ended March 31,</b>					
	<b>2019</b>			<b>2018</b>		
Industrial	\$ 168,660	31.3	%	\$ 100,100	21.5	%
Education	66,743	12.4	%	88,203	19.0	%
Office Buildings	66,212	12.3	%	69,120	14.9	%
Healthcare	92,023	17.1	%	63,183	13.6	%
Government	32,279	6.0	%	36,147	7.8	%
Retail, Restaurants and Entertainment	59,391	11.0	%	52,787	11.3	%
Multi-Family and Residential	30,235	5.6	%	33,052	7.1	%
Other	22,931	4.3	%	22,349	4.8	%
Total	\$ 538,473	100.0	%	\$ 464,941	100.0	%

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<b>Revenue by Activity Type</b>	<b>Three Months Ended March 31,</b>					
	<b>2019</b>			<b>2018</b>		
New Construction	\$ 223,961	41.6 %		\$ 185,282	39.9 %	
Existing Building Construction	182,296	33.8 %		156,758	33.7 %	
Service Projects	50,384	9.4 %		42,433	9.1 %	
Service Calls, Maintenance and Monitoring	81,833	15.2 %		80,468	17.3 %	
Total	\$ 538,473	100.0 %		\$ 464,941	100.0 %	

***Accounts Receivable***

Accounts Receivable, include amounts from work completed in which we have billed or have an unconditional right to bill our customers. The amounts due are stated at their net estimated realizable value. We maintain an allowance for doubtful accounts to provide for the estimated amount of receivables that will not be collected. The allowance is based upon an assessment of customer creditworthiness, historical payment experience, the age of outstanding receivables and collateral to the extent applicable.

***Contract Assets and Liabilities***

Contract assets include unbilled amounts typically resulting from sales under long term contracts when the cost to cost method of revenue recognition is used and revenue recognized exceeds the amount billed to the customer and right to payment is conditional, subject to completing a milestone, such as a phase of the project. Contract assets are generally classified as current.

Contract liabilities consist of advance payments and billings in excess of revenue recognized. Our contract assets and liabilities are reported in a net position on a contract by contract basis at the end of each reporting period. We classify advance payments and billings in excess of revenue recognized as current. It is very unusual for us to have advanced payments with a term of greater than one year; therefore, our contract assets are usually all current. If we have advanced payments with a term greater than one year, the noncurrent portion of advanced payments would be included in other long-term liabilities in our consolidated balance sheets.

The following table presents the changes in contract assets and contract liabilities (in thousands):

	<b>Three Months Ended</b>	<b>Year Ended</b>
--	---------------------------	-------------------

	<b>March 31, 2019</b>		<b>December 31, 2018</b>	
	<b>Contract Assets</b>	<b>Contract Liabilities</b>	<b>Contract Assets</b>	<b>Contract Liabilities</b>
Balance at beginning of period	\$ 10,213	\$ 130,986	\$ 30,116	\$ 106,005
Change due to acquisitions	27	44	2,833	8,195
Change due to conditional versus unconditional	(1,954)	—	6,244	—
Reclassified to unbilled accounts receivable	—	—	(28,980)	—
Change in timing for performance obligation to be satisfied	—	(10,740)	—	16,786
Balance at end of period	\$ 8,286	\$ 120,290	\$ 10,213	\$ 130,986

In the first three months of 2019 and 2018, we recognized revenue of \$105.6 million and \$85.5 million related to our contract liabilities at January 1, 2019 and January 1, 2018, respectively.

We did not have any impairment losses recognized on our receivables or contract assets in the first three months of 2019 and 2018.

### ***Remaining Performance Obligations***

Remaining construction performance obligations represent the remaining transaction price of firm orders for which work has not been performed and excludes unexercised contract options. As of March 31, 2019, the aggregate amount of the transaction price allocated to remaining performance obligations was \$1.14 billion. The Company expects to recognize revenue on approximately 85% of the remaining performance obligations over the next 12 months, with the

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remaining recognized thereafter. Our service maintenance agreements are generally one-year renewable agreements. We have adopted the practical expedient that allows us to not include service maintenance contracts one year or less, therefore we do not report unfulfilled performance obligations for service maintenance agreements.

*Leases*

We lease certain facilities, vehicles and equipment under noncancelable operating leases. The most significant portion of these noncancelable operating leases are for the facilities occupied by our corporate office and our operating locations. Leases with an initial term of 12 months or less are not recorded on the balance sheet. We account for lease components separately from the non-lease components. We have certain leases with variable payments based on an index as well as some short-term leases on equipment and facilities. Variable lease expense and short-term lease expense was not material to our financial statements and aggregated to \$1.9 million in the first quarter of 2019. Lease right-of-use assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we generally use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The weighted average discount rate as of March 31, 2019 was 4.1%. We recognize lease expense, including escalating lease payments and excluding lease incentives, on a straight-line basis over the lease term. Lease expense for the three months ended March 31, 2019 and 2018 was \$5.6 million and \$5.2 million, respectively.

The lease terms generally range from three to ten years. Some leases include one or more options to renew, with renewal terms that can extend the lease term. Our lease terms may include the exercise of lease renewal options when it is reasonably certain that we will exercise the option and it is at our sole discretion. The weighted average remaining lease term was 8.6 years at March 31, 2019.

A majority of the Company's real property leases are with individuals or entities with whom we have no other business relationship. However, in certain instances the Company enters into real property leases with current or former employees. Rent paid to related parties for the three months ended March 31, 2019 and 2018 was approximately \$1.2 million and \$1.1 million, respectively.

If we decide to cancel or terminate a lease before the end of its term, we would typically owe the lessor the remaining lease payments under the term of the lease. Our lease agreements do not contain any material residual value guarantees or material restrictive covenants. On rare occasions we rent or sublease certain real estate assets that we no longer use to third parties.

The following table summarizes the lease asset and liabilities included in the consolidated balance sheet as follows (in thousands):



**March  
31,  
2019**

Lease right-of-use assets \$ 70,316

Lease liabilities:

Other current liabilities 11,066

Long-term lease liabilities 62,028

Total lease liabilities \$ 73,094

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The maturities of lease liabilities are as follows (in thousands):

Year ending December 31—	
2019 (excluding the three months ended March 31, 2019)	\$ 10,687
2020	12,508
2021	11,341
2022	9,410
2023	7,821
Thereafter	35,541
Total Lease Payments	87,308
Less—Present Value Discount	(14,214)
Present Value of Lease Liabilities	\$ 73,094

Supplemental information related to leases was as follows (in thousands):

	<b>Three Months Ended March 31, 2019</b>
Cash paid for amounts included in the measurement of lease liabilities	\$ 5,904
Lease right-of-use assets obtained in exchange for lease liabilities	\$ 174

***Income Taxes***

We conduct business throughout the United States in virtually all fifty states. Our effective tax rate changes based upon our relative profitability, or lack thereof, in states with varying tax rates and rules. In addition, discrete items, such as tax law changes, judgments and legal structures can impact our effective tax rate. These items can also include the tax treatment for impairment of goodwill and other intangible assets, changes in fair value of acquisition-related assets and liabilities, tax reserves for uncertain tax positions, accounting for losses associated with underperforming operations and noncontrolling interests.

Our provision for income taxes was reduced by \$2.8 million in the first quarter of 2018 due to a decrease in unrecognized tax benefits from the filing of a federal income tax automatic accounting method change application.

### ***Financial Instruments***

Our financial instruments consist of cash and cash equivalents, accounts receivable, other receivables, accounts payable, life insurance policies, notes to former owners, leases and a revolving credit facility. We believe that the carrying values of these instruments on the accompanying balance sheets approximate their fair values.

### ***Segment Disclosure***

Our activities are within the mechanical services industry, which is the single industry segment we serve. Each operating unit represents an operating segment and these segments have been aggregated, as the operating units meet all of the aggregation criteria.

## **3. Fair Value Measurements**

We classify and disclose assets and liabilities carried at fair value in one of the following three categories:

Level 1—quoted prices in active markets for identical assets and liabilities;

Level 2—observable market based inputs or unobservable inputs that are corroborated by market data; and

Level 3—significant unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

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The following table summarizes the fair values, and levels within the fair value hierarchy in which the fair value measurements fall, for assets and liabilities measured on a recurring basis as of March 31, 2019 and December 31, 2018 (in thousands):

	<b>Fair Value Measurements at March 31, 2019</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 29,130	\$ —	\$ —	\$ 29,130
Life insurance—cash surrender value	\$ —	\$ 3,446	\$ —	\$ 3,446
Contingent earn-out obligations	\$ —	\$ —	\$ 6,939	\$ 6,939

	<b>Fair Value Measurements at December 31, 2018</b>			
	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
Cash and cash equivalents	\$ 45,620	\$ —	\$ —	\$ 45,620
Life insurance—cash surrender value	\$ —	\$ 3,252	\$ —	\$ 3,252
Contingent earn-out obligations	\$ —	\$ —	\$ 7,375	\$ 7,375

Cash and cash equivalents consist primarily of highly rated money market funds at a variety of well-known institutions with original maturities of three months or less. The original cost of these assets approximates fair value due to their short-term maturity. The carrying value of our borrowings associated with the Revolving Credit Facility approximate its fair value due to the variable rate on such debt.

We have life insurance policies covering 62 employees with a combined face value of \$44.5 million. The policies are invested in several investment vehicles and the fair value measurement of the cash surrender balance associated with these policies is determined using Level 2 inputs within the fair value hierarchy and will vary with investment performance. The cash surrender value of these policies was \$3.4 million as of March 31, 2019 and \$3.3 million as of December 31, 2018. These assets are included in “Other Noncurrent Assets” in our consolidated balance sheets.

We value contingent earn-out obligations using a probability weighted discounted cash flow method. This fair value measurement is based on significant unobservable inputs in the market and thus represents a Level 3 measurement within the fair value hierarchy. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payments, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate. The contingent earn-out obligations are measured at fair value each reporting period and changes in estimates of fair value are recognized in earnings.

The table below presents a reconciliation of the fair value of our contingent earn-out obligations that use significant unobservable inputs (Level 3) (in thousands).

Balance at beginning of year	\$ 7,375
Issuances	—
Settlements	(594)
Adjustments to fair value	158
Balance at March 31, 2019	\$ 6,939

We measure certain assets at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. We did not recognize any impairments, in the current quarter, on those assets required to be measured at fair value on a nonrecurring basis.

#### 4. Acquisitions

We completed one acquisition in the first quarter of 2019 with a total purchase price of \$1.6 million for the three months ended March 31, 2019. We completed two acquisitions in the first quarter of 2018, three acquisitions in the second quarter of 2018 and two acquisitions in the third quarter of 2018. One acquisition completed in the third quarter

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of 2018 reports as a separate operating location and the remainder were “tucked-in” with existing operations. Our consolidated balance sheet includes preliminary allocations of the purchase price to the assets acquired and liabilities assumed pending the completion of the final valuation of intangible assets and accrued liabilities.

The results of operations of acquisitions are included in our consolidated financial statements from their respective acquisition dates. Our consolidated balance sheet includes preliminary allocations of the purchase price to the assets acquired and liabilities assumed for the applicable acquisitions pending the completion of the final valuation of intangible assets and accrued liabilities. The acquisitions completed in the current and prior year were not material, individually or in the aggregate. Additional contingent purchase price (“earn-out”) has been or will be paid if certain acquisitions achieve predetermined profitability targets. Such earn-outs, which are not subject to the continued employment of the sellers, are estimated as of the purchase date and included as part of the consideration paid for the acquisition. If we have an earn-out where continued employment is a condition to receive payment, then the earn-out is recorded as compensation expense over the period earned.

**5. Goodwill**

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

	<b>March 31, 2019</b>	<b>December 31, 2018</b>
Balance at beginning of year	\$ 235,182	\$ 200,584
Additions (See Note 4)	678	34,598
Impairment adjustment	—	—
Balance at end of period	\$ 235,860	\$ 235,182

**6. Debt Obligations**

Debt obligations consist of the following (in thousands):

	<b>March 31, 2019</b>	<b>December 31, 2018</b>
Revolving credit facility	\$ 51,000	\$ 50,000
Notes to former owners	26,150	26,813
Other debt	89	105
Total debt	77,239	76,918
Less—current portion	(2,755)	(3,279)
Total long-term portion of debt	\$ 74,484	\$ 73,639

### *Revolving Credit Facility*

On April 18, 2018, we amended our senior credit facility (the “Facility”) provided by a syndicate of banks, increasing our borrowing capacity from \$325.0 million to \$400.0 million, with a \$100 million accordion option. The Facility, which is available for borrowings and letters of credit, expires in April 2023 and is secured by a first lien on substantially all of our personal property except for assets related to projects subject to surety bonds and assets held by certain unrestricted subsidiaries and a second lien on our assets related to projects subject to surety bonds. As of March 31, 2019, we had \$51.0 million of outstanding borrowings, \$33.6 million in letters of credit outstanding and \$315.4 million of credit available.

There are two interest rate options for borrowings under the Facility, the Base Rate Loan Option and the Eurodollar Rate Loan Option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

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The following is a summary of the additional margins:

	<b>Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA</b>			
	<b>Less than 1.00</b>	<b>1.00 to 1.75</b>	<b>1.75 to 2.50</b>	<b>2.50 or greater</b>
Additional Per Annum Interest Margin Added Under:				
Base Rate Loan Option	0.25	% 0.50	% 0.75	% 1.00
Eurodollar Rate Loan Option	1.25	% 1.50	% 1.75	% 2.00

The weighted average interest rate applicable to the borrowings under the Facility was approximately 3.7% as of March 31, 2019.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. Our lenders issue such letters of credit through the Facility. We have never had a claim made against a letter of credit that resulted in payments by a lender or by us and believe such a claim is unlikely in the foreseeable future. The letter of credit fees range from 1.25% to 2.00% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20% to 0.35% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. Covenant compliance is assessed as of each quarter end.

The Facility's principal financial covenants include:

*Total Leverage Ratio*—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed 3.00 to 1.00 as of the end of each fiscal quarter. The total leverage ratio as of March 31, 2019 was 0.4.



*Fixed Charge Coverage Ratio*—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, provision for income taxes, dividends and amounts used to repurchase stock to (b) the sum of interest expense and scheduled principal payments of indebtedness be at least 2.00 to 1.00; provided that the calculation of the fixed charge coverage ratio excludes stock repurchases and the payment of dividends at any time that the Company's Net Leverage Ratio, as defined in the credit agreement, does not exceed 1.75 to 1.00. The Facility also allows the fixed charge coverage ratio not to be reduced for stock repurchases made after the effective date of the Facility in an aggregate amount not to exceed \$30 million, if at the time of and after giving effect to such repurchase the Company's Net Leverage Ratio was less than or equal to 1.75 to 1.00. Credit Facility Adjusted EBITDA, capital expenditures, provision for income taxes, dividends, stock repurchase payments, interest expense, and scheduled principal payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of March 31, 2019 was 22.6.

*Other Restrictions*—The Facility permits acquisitions of up to \$40.0 million per transaction, provided that the aggregate purchase price of all such acquisitions in the same fiscal year does not exceed \$80.0 million. However, these limitations only apply when the Company's Total Leverage Ratio is greater than 2.00 to 1.00.

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While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility's leverage ratio covenant, our borrowing capacity under the Facility and the favorable terms that we currently have could be negatively impacted by the lenders.

We were in compliance with all of our financial covenants as of March 31, 2019.

## *Notes to Former Owners*

As part of the consideration used to acquire six companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$26.2 million as of March 31, 2019. In conjunction with an acquisition in the first quarter of 2019, we issued a promissory note to former owners with an outstanding balance of \$0.4 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in January 2021. In conjunction with an acquisition in the third quarter of 2018, we issued a promissory note to former owners with an outstanding balance of \$6.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.5%. The principal is due in three equal installments in July 2019, 2020 and 2021. In conjunction with a separate acquisition in the third quarter of 2018, we issued a promissory note to former owners with an outstanding balance of \$3.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 2.9%. The principal is due in September 2020. In conjunction with a small acquisition in the second quarter of 2018, we issued a subordinated note to former owners with an outstanding balance of \$1.0 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.5%. The principal is due in equal installments in May 2020 and 2021. In conjunction with a small acquisition in the first quarter of 2018, we issued a subordinated note to former owners with an outstanding balance of \$0.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in January 2020. In conjunction with the BCH acquisition in the second quarter of 2017, we issued a promissory note to former owners with an outstanding balance of \$14.3 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in equal installments in April 2020 and 2021.

## *Other Debt*

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principal and interest due the last day of every month; ending on the December 30, 2019 maturity date. The interest rate is the one month LIBOR rate plus 2.25%. As of March 31, 2019, \$0.1 million of the note was outstanding, all of which was considered current.

## **7. Commitments and Contingencies**

### *Claims and Lawsuits*

We are subject to certain legal and regulatory claims, including lawsuits arising in the normal course of business. We maintain various insurance coverages to minimize financial risk associated with these claims. We have estimated and provided accruals for probable losses and related legal fees associated with certain litigation in the accompanying consolidated financial statements. While we cannot predict the outcome of these proceedings, in management's opinion and based on reports of counsel, any liability arising from these matters individually and in the aggregate will not have a material effect on our operating results, cash flows or financial condition, after giving effect to provisions already recorded.

### *Surety*

Many customers, particularly in connection with new construction, require us to post performance and payment bonds issued by a financial institution known as a surety. If we fail to perform under the terms of a contract or to pay subcontractors and vendors who provided goods or services under a contract, the customer may demand that the surety make payments or provide services under the bond. We must reimburse the surety for any expenses or outlays it incurs. To date, we are not aware of any losses to our sureties in connection with bonds the sureties have posted on our behalf, and do not expect such losses to be incurred in the foreseeable future.

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Surety market conditions have seen some strengthening as the commercial construction markets have started to rebound. Bonding capacity remains adequate in the current market conditions along with acceptable terms and conditions. Historically, approximately 20% to 30% of our business has required bonds. While we currently have strong surety relationships to support our bonding needs, future market conditions or changes in the sureties' assessment of our operating and financial risk could cause the sureties to decline to issue bonds for our work. If that were to occur, the alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenue and profits to decline in the near term.

### *Self-Insurance*

We are substantially self-insured for workers' compensation, employer's liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident deductibles we absorb under our insurance arrangements for these risks. Losses are estimated and accrued based upon known facts, historical trends and industry averages. Estimated losses in excess of our deductible, which have not already been paid, are included in our accrual with a corresponding receivable from our insurance carrier. Loss estimates associated with the larger and longer-developing risks, such as workers' compensation, auto liability and general liability, are reviewed by a third-party actuary quarterly.

## **8. Stockholders' Equity**

### *Earnings Per Share*

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year. Diluted EPS is computed considering the dilutive effect of stock options, restricted stock, restricted stock units and performance stock units. The vesting of unvested contingently issuable performance stock units is based on the achievement of certain earnings per share targets and total shareholder return. These shares are considered contingently issuable shares for purposes of calculating diluted earnings per share. These shares are not included in the diluted earnings per share denominator until the performance criteria are met, if it is assumed that the end of the reporting period was the end of the contingency period.

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Unvested restricted stock, restricted stock units and performance stock units are included in diluted earnings per share, weighted outstanding until the shares and units vest. Upon vesting, the vested restricted stock, restricted stock units and performance stock units are included in basic earnings per share weighted outstanding from the vesting date.

There were less than 0.1 million anti-dilutive stock options excluded from the calculation of diluted EPS for the three months ended March 31, 2019 and 2018, respectively.

The following table reconciles the number of shares outstanding with the number of shares used in computing basic and diluted earnings per share for each of the periods presented (in thousands):

	<b>Three Months Ended March 31,</b>	
	<b>2019</b>	<b>2018</b>
Common shares outstanding, end of period	36,891	37,088
Effect of using weighted average common shares outstanding	32	104
Shares used in computing earnings per share—basic	36,923	37,192
Effect of shares issuable under stock option plans based on the treasury stock method	230	317
Effect of restricted and contingently issuable shares	81	119
Shares used in computing earnings per share—diluted	37,234	37,628

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***Share Repurchase Program***

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On August 10, 2018, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.7 million shares. Since the inception of the repurchase program, the Board has approved 8.8 million shares to be repurchased. As of March 31, 2019, we have repurchased a cumulative total of 8.3 million shares at an average price of \$16.51 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. During the three months ended March 31, 2019, we repurchased 0.1 million shares for approximately \$3.3 million at an average price of \$49.27 per share.

**9. Subsequent Events**

On April 1, 2019, we acquired all of the issued and outstanding equity interests of Walker TX Holding Company, LLC and each of its wholly-owned subsidiaries (collectively “Walker”) pursuant to the terms of the Purchase Agreement (the “Purchase Agreement”) dated as of February 21, 2019. The purchase price consisted of \$178 million in cash at closing, subject to working capital and certain other post-closing adjustments as set forth in the purchase agreement and \$25 million in a promissory note that is payable in two equal installments of \$12.5 million on the third and fourth anniversaries of the closing date, plus an earn out that we will pay if certain financial targets are met after the acquisition date. As of closing, we also funded a \$20.5 million advance that we expect to recover as part of the working capital settlement and other contingent future payments. Walker is a full-service electrical contracting and network infrastructure engineering business serving commercial and industrial clients with headquarters in Irving, Texas and operations throughout the state of Texas. The transaction was primarily funded from the Company’s revolving credit facility.

Beginning on or about April 14, 2019, the Comfort Systems USA, Inc. information technology infrastructure was impacted by a ransomware attack virus. As a result, a substantial majority of our operating locations experienced loss of access to certain data and outages affecting systems including accounting, payroll, billing, job report and management and other software environments. Our first quarter financial results were not affected by this incident. We expect to incur certain costs and experience inefficiencies and delays associated with the incident and our response efforts that might not be covered by existing insurance, and which could adversely affect our financial results in future periods. We anticipate that any such costs, inefficiencies and delays would likely be incurred during our second quarter of 2019 and could also impact the timing of our cash flows in the short and intermediate term. We do not believe that this incident will have a long-term material adverse impact on our business, results of operations or

financial condition.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis should be read in conjunction with our historical Consolidated Financial Statements and related notes included elsewhere in this Form 10-Q and the Annual Report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2018 (the "Form 10-K"). This discussion contains "forward-looking statements" regarding our business and industry within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on our current plans and expectations and involve risks and uncertainties that could cause our actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in "Item 1A. Risk Factors" included in our Form 10-K. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. The terms "Comfort Systems," "we," "us," or the "Company," refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

***Introduction and Overview***

We are a national provider of comprehensive mechanical installation, renovation, maintenance, repair and replacement services within the mechanical services industry. We operate primarily in the commercial, industrial and institutional HVAC markets and perform most of our services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities.

***Nature and Economics of Our Business***

Approximately 84.8% of our revenue is earned on a project basis for installation of mechanical systems in newly constructed facilities or for replacement of systems in existing facilities. Customers hire us to ensure such systems deliver specified or generally expected heating, cooling, conditioning and circulation of air in a facility. This entails installing core system equipment such as packaged heating and air conditioning units, or in the case of larger facilities, separate core components such as chillers, boilers, air handlers, and cooling towers. We also typically install connecting and distribution elements such as piping and ducting. Our responsibilities usually require conforming the systems to pre-established engineering drawings and equipment and performance specifications, which we frequently participate in establishing. Our project management responsibilities include staging equipment and materials to project sites, deploying labor to perform the work, and coordinating with other service providers on the project, including any subcontractors we might use to deliver our portion of the work.

When competing for project business, we usually estimate the costs we will incur on a project, and then propose a bid to the customer that includes a contract price and other performance and payment terms. Our bid price and terms are



intended to cover our estimated costs on the project and provide a profit margin to us commensurate with the value of the installed system to the customer, the risk that project costs or duration will vary from estimate, the schedule on which we will be paid, the opportunities for other work that we might forego by committing capacity to this project, and other costs that we incur to support our operations but which are not specific to the project. Typically customers will seek pricing from competitors for a given project. While the criteria on which customers select a service provider vary widely and include factors such as quality, technical expertise, on-time performance, post-project support and service, and company history and financial strength, we believe that price for value is the most influential factor for most customers in choosing a mechanical installation and service provider.

After a customer accepts our bid, we generally enter into a contract with the customer that specifies what we will deliver on the project, what our related responsibilities are, and how much and when we will be paid. Our overall price for the project is typically set at a fixed amount in the contract, although changes in project specifications or work conditions that result in unexpected additional work are usually subject to additional payment from the customer via what are commonly known as change orders. Project contracts typically provide for periodic billings to the customer as we meet progress milestones or incur cost on the project. Project contracts in our industry also frequently allow for a small portion of progress billings or contract price to be withheld by the customer until after we have completed the work. Amounts withheld under this practice are known as retention or retainage.

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Labor and overhead costs account for the majority of our cost of service. Accordingly, labor management and utilization have the most impact on our project performance. Given the fixed price nature of much of our project work, if our initial estimate of project costs is wrong or we incur cost overruns that cannot be recovered in change orders, we can experience reduced profits or even significant losses on fixed price project work. We also perform some project work on a cost-plus or a time and materials basis, under which we are paid our costs incurred plus an agreed-upon profit margin, and such projects are sometimes subject to a guaranteed maximum cost. These margins are frequently less than fixed-price contract margins because there is less risk of unrecoverable cost overruns in cost-plus or time and materials work.

As of March 31, 2019 we had 5,112 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$594,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. We have what we believe is a well-diversified distribution of revenue across end-use sectors that we believe reduces our exposure to negative developments in any given sector. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

A stratification of projects in progress as of March 31, 2019, by contract price, is as follows:

<b>Contract Price of Project</b>	<b>No. of Projects</b>	<b>Aggregate Contract Price Value (millions)</b>
Under \$1 million	4,511	\$ 592.3
\$1 million - \$5 million	484	1,070.2
\$5 million - \$10 million	71	499.8
\$10 million - \$15 million	24	296.7
Greater than \$15 million	22	579.2
<b>Total</b>	<b>5,112</b>	<b>\$ 3,038.2</b>

In addition to project work, approximately 15.2% of our revenue represents maintenance and repair service on already installed HVAC and controls systems. This kind of work usually takes from a few hours to a few days to perform. Prices to the customer are based on the equipment and materials used in the service as well as technician labor time. We usually bill the customer for service work when it is complete, typically with payment terms of up to thirty days. We also provide maintenance and repair service under ongoing contracts. Under these contracts, we are paid regular monthly or quarterly amounts and provide specified service based on customer requirements. These agreements

typically are for one or more years and frequently contain thirty- to sixty-day cancellation notice periods.

A relatively small portion of our revenue comes from national and regional account customers. These customers typically have multiple sites, and contract with us to perform maintenance and repair service. These contracts may also provide for us to perform new or replacement systems installation. We operate a national call center to dispatch technicians to sites requiring service. We perform the majority of this work with our own employees, with the balance being subcontracted to third parties that meet our performance qualifications.

### ***Profile and Management of Our Operations***

We manage our 35 operating units based on a variety of factors. Financial measures we emphasize include profitability, and use of capital as indicated by cash flow and by other measures of working capital principally involving project cost, billings and receivables. We also monitor selling, general, administrative and indirect project support expense, backlog, workforce size and mix, growth in revenue and profits, variation of actual project cost from original estimate, and overall financial performance in comparison to budget and updated forecasts. Operational factors we emphasize include project selection, estimating, pricing, management and execution practices, labor utilization, safety,

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training, and the make-up of both existing backlog as well as new business being pursued, in terms of project size, technical application and facility type, end-use customers and industries, and location of the work.

Most of our operations compete on a local or regional basis. Attracting and retaining effective operating unit managers is an important factor in our business, particularly in view of the relative uniqueness of each market and operation, the importance of relationships with customers and other market participants such as architects and consulting engineers, and the high degree of competition and low barriers to entry in most of our markets. Accordingly, we devote considerable attention to operating unit management quality, stability, and contingency planning, including related considerations of compensation, and non-competition protection where applicable.

### ***Economic and Industry Factors***

As a mechanical and building controls services provider, we operate in the broader nonresidential construction services industry and are affected by trends in this sector. While we do not have operations in all major cities of the United States, we believe our national presence is sufficiently large that we experience trends in demand for and pricing of our services that are consistent with trends in the national nonresidential construction sector. As a result, we monitor the views of major construction sector forecasters along with macroeconomic factors they believe drive the sector, including trends in gross domestic product, interest rates, business investment, employment, demographics, and the fiscal condition of federal, state and local governments.

Spending decisions for building construction, renovation and system replacement are generally made on a project basis, usually with some degree of discretion as to when and if projects proceed. With larger amounts of capital, time, and discretion involved, spending decisions are affected to a significant degree by uncertainty, particularly concerns about economic and financial conditions and trends. We have experienced periods of time when economic weakness caused a significant slowdown in decisions to proceed with installation and replacement project work.

### ***Operating Environment and Management Emphasis***

Nonresidential building construction and renovation activity, as reported by the federal government, declined steeply over the four-year period from 2009 to 2012, and 2013 and 2014 activity levels were relatively stable at the low levels of the preceding years. During the four-year period from 2015 to 2018, there was an increase in overall activity levels and we currently expect that activity will continue at these improved levels during 2019.

As a result of our continued strong emphasis on cash flow, at March 31, 2019 we had modest indebtedness under our revolving credit facility, with positive uncommitted cash balances, as discussed further in “Liquidity and Capital

Resources” below. We have a credit facility in place with terms we believe are favorable that does not expire until April 2023. We have strong surety relationships to support our bonding needs, and we believe our relationships with the surety markets are strong and benefit from our operating history and financial position. We have generated positive free cash flow in each of the last twenty calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our balance sheet and surety relationships as compared to most companies in our industry represent competitive advantages for us.

As discussed at greater length in “Results of Operations” below, we expect price competition to continue as our customers and local and regional competitors respond cautiously to improved market conditions. We will continue to invest in our service business, to pursue the more active sectors in our markets, and to emphasize our regional and national account business. Our primary emphasis for 2019 is on execution and cost control, but we are seeking growth based on our belief that industry conditions will continue to be strong in the near term, and we believe that activity levels will permit us to continue to earn solid profits while preserving and developing our workforce. We continue to focus on project qualification, estimating, pricing and management; and we are investing in growth and improved performance.

### *Cyclicality and Seasonality*

Historically, the construction industry has been highly cyclical. As a result, our volume of business, particularly in new construction projects and renovation, may be adversely affected by declines in new installation and replacement projects in various geographic regions of the United States during periods of economic weakness.

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The HVAC industry is subject to seasonal variations. The demand for new installation and replacement is generally lower during the winter months (the first quarter of the year) due to reduced construction activity during inclement weather and less use of air conditioning during the colder months. Demand for HVAC services is generally higher in the second and third calendar quarters due to increased construction activity and increased use of air conditioning during the warmer months. Accordingly, we expect our revenue and operating results generally will be lower in the first calendar quarter.

**Results of Operations (dollars in thousands):**

	<b>Three Months Ended March 31,</b>					
	<b>2019</b>			<b>2018</b>		
Revenue	\$ 538,473	100.0	%	\$ 464,941	100.0	%
Cost of services	431,808	80.2	%	375,888	80.8	%
Gross profit	106,665	19.8	%	89,053	19.2	%
Selling, general and administrative expenses	78,905	14.7	%	70,023	15.1	%
Gain on sale of assets	(219)	—		(211)	—	
Operating income	27,979	5.2	%	19,241	4.1	%
Interest income	25	—		14	—	
Interest expense	(1,062)	(0.2)	%	(713)	(0.2)	%
Changes in the fair value of contingent earn-out obligations	(158)	—		153	—	
Other income (expense)	15	—		38	—	
Income before income taxes	26,799	5.0	%	18,733	4.0	%
Provision for income taxes	6,933			2,074		
Net income	\$ 19,866	3.7	%	\$ 16,659	3.6	%

We had 36 operating locations as of December 31, 2018. In the first quarter of 2019, we combined two operating locations into one. As of March 31, 2019, we had 35 operating locations. Acquisitions are included in our results of operations from the respective acquisition date. The same-store comparison from 2019 to 2018, as described below, excludes three months of results for the Indiana acquisition, which was acquired July 1, 2018. An operating location is included in the same-store comparison on the first day it has comparable prior year operating data, except for immaterial acquisitions that were absorbed and integrated, or “tucked-in”, with existing operations.

*Revenue*—Revenue increased \$73.5 million, or 15.8%, to \$538.5 million for the first quarter of 2019 compared to the same period in 2018. The increase included a 6.0% increase related to the Indiana acquisition and a 9.8% increase in revenue related to same-store activity. The same-store revenue increase was broad-based, including an increase in activity at two of our Virginia operations (\$15.2 million), our North Carolina operation (\$11.2 million), one of our Florida operations (\$7.4 million) and our Alabama operation (\$6.6 million). This increase was offset by a decrease in activity at one of our Texas operations (\$9.3 million).

Backlog reflects revenue still to be recognized under contracted or committed installation and replacement project work. Project work generally lasts less than one year. Service agreement revenue and service work and short duration projects, which are generally billed as performed, do not flow through backlog. Accordingly, backlog represents only a portion of our revenue for any given future period, and it represents revenue that is likely to be reflected in our operating results over the next six to twelve months. As a result, we believe the predictive value of backlog information is limited to indications of general revenue direction over the near term, and should not be interpreted as indicative of ongoing revenue performance over several quarters.

Backlog as of March 31, 2019 was \$1.14 billion, a 2.0% decrease from December 31, 2018 backlog of \$1.17 billion, and a 5.9% increase from March 31, 2018 backlog of \$1.08 billion. Sequential backlog decreased primarily due to completion of project work at one of our Virginia operations (\$24.1 million) and one of our Florida operations (\$17.1 million), which was partially offset by increased project bookings at one of our Texas operations (\$17.6 million). The year over year backlog increase included the Indiana acquisition (\$18.2 million) and a same-store increase of \$45.6 million or 4.2%. Same-store year-over-year backlog increased primarily due to increased project bookings at one of our Texas operations (\$42.8 million) and one of our Florida operations (\$29.4 million), partially offset by a completion of project work at one of our Maryland operations (\$24.2 million).

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*Gross Profit*—Gross profit increased \$17.6 million, or 19.8%, to \$106.7 million for the first quarter of 2019 as compared to the same period in 2018. The increase included a 3.7% increase related to the Indiana acquisition and a 16.1% increase in same-store activity. The same-store increase in gross profit was primarily due to increased volumes at one of our Virginia operations (\$1.5 million). Additionally, we had improvements in project execution at our North Carolina operation (\$3.0 million), one of our Florida operations (\$2.8 million) and one of our Tennessee operations (\$1.7 million) compared to the prior year. As a percentage of revenue, gross profit increased from 19.2% in 2018 to 19.8% in 2019 primarily due to the improvement in project execution at our North Carolina operation as previously discussed.

*Selling, General and Administrative Expenses (“SG&A”)*—SG&A increased \$8.9 million, or 12.7%, to \$78.9 million for the first quarter of 2019 as compared to 2018. On a same-store basis, excluding amortization expense, SG&A increased \$6.1 million, or 9.2%. This increase is primarily due to the increase in revenue and increased compensation costs related to earnings growth compared to the prior year period. Additionally, we had an increase in amortization expense of \$1.0 million during the period as compared to the prior year period, primarily as a result of the Indiana acquisition. As a percentage of revenue, SG&A decreased from 15.1% in 2018 to 14.7% in 2019.

We have included same-store SG&A, excluding amortization, because we believe it is an effective measure of comparative results of operations. However, same-store SG&A, excluding amortization, is not considered under generally accepted accounting principles to be a primary measure of an entity’s financial results, and accordingly, should not be considered an alternative to SG&A as shown in our consolidated statements of operations.

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2019</b>	<b>2018</b>
	<b>(in thousands)</b>	
SG&A	\$ 78,905	\$ 70,023
Less: SG&A from companies acquired	(1,776)	—
Less: Amortization expense	(4,388)	(3,416)
Same-store SG&A, excluding amortization expense	\$ 72,741	\$ 66,607

*Interest Expense*—Interest expense increased \$0.3 million, or 48.9%, to \$1.1 million for the first quarter of 2019 as compared to the same period in 2018. The increase reflects the increased borrowings on the revolving credit facility and notes to former owners as a result of our recent acquisitions.



*Changes in the Fair Value of Contingent Earn-out Obligations*—The contingent earn-out obligations are measured at fair value each reporting period and changes in estimates of fair value are recognized in earnings. Income from changes in the fair value of contingent earn-out obligations for the first quarter of 2019 decreased \$0.3 million as compared to the same period in 2018. This decrease was primarily the result of increasing our obligation related to one of our Florida operations acquired in 2017.

*Provision for Income Taxes*—Our provision for income taxes for the three months ended March 31, 2019 was \$6.9 million with an effective tax rate of 25.9% as compared to a provision for income taxes of \$2.1 million with an effective tax rate of 11.1% for the same period in 2018. The effective tax rate for 2019 was higher than the 21% federal statutory rate primarily due to net state income taxes (4.4%) and nondeductible expenses (1.4%) partially offset by deductions for stock-based compensation (0.9%). The effective tax rate for 2018 was lower than the 21% federal statutory rate primarily due to a decrease in unrecognized tax benefits from the filing of a federal income tax automatic accounting method change application (14.8%) partially offset by net state income taxes (4.4%) and nondeductible expenses (0.9%).

We currently estimate our effective tax rate for the full year 2019 will be between 25% and 30%. We generally expect our tax rate in 2019 to be higher than 2018 due to the nonrecurring benefit from the decrease in unrecognized tax benefits from the filing of a federal income tax automatic accounting method change application.

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Industry conditions improved during the three-year period from 2016 to 2018 and we currently expect that activity will continue at these improved levels during 2019. Our emphasis for 2019 is on cost discipline and efficient project performance, labor force development, and investing in growth, particularly in service and small projects. Based on our backlog, and in light of economic conditions, we currently expect that revenue and net earnings in 2019 will continue at the favorable levels we experienced in 2018.

**Liquidity and Capital Resources (in thousands):**

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2019</b>	<b>2018</b>
Cash provided by (used in):		
Operating activities	\$ 991	\$ 3,851
Investing activities	(9,800)	(11,941)
Financing activities	(7,681)	(3,233)
Net decrease in cash and cash equivalents	\$ (16,490)	\$ (11,323)
Free cash flow:		
Cash provided by operating activities	\$ 991	\$ 3,851
Purchases of property and equipment	(8,844)	(5,588)
Proceeds from sales of property and equipment	357	366
Free cash flow	\$ (7,496)	\$ (1,371)

**Cash Flow**

Our business does not require significant amounts of investment in long-term fixed assets. The substantial majority of the capital used in our business is working capital that funds our costs of labor and installed equipment deployed in project work until our customer pays us. Customary terms in our industry allow customers to withhold a small portion of the contract price until after we have completed the work, typically for six months. Amounts withheld under this practice are known as retention or retainage. Our average project duration together with typical retention terms generally allow us to complete the realization of revenue and earnings in cash within one year.

*Cash Provided by Operating Activities*—Cash flow from operations is primarily influenced by demand for our services and operating margins, but can also be influenced by working capital needs associated with the various types of services that we provide. In particular, working capital needs may increase when we commence large volumes of work under circumstances where project costs, primarily associated with labor, equipment and subcontractors, are required to be paid before the receivables resulting from the work performed are billed and collected. Working capital needs are generally higher during the late winter and spring months as we prepare and plan for the increased project demand when favorable weather conditions exist in the summer and fall months. Conversely, working capital assets are typically converted to cash during the late summer and fall months as project completion is underway. These seasonal trends are sometimes offset by changes in the timing of major projects, which can be impacted by the weather, project delays or accelerations and other economic factors that may affect customer spending.

Cash provided by operating activities was \$1.0 million during the first three months of 2019 compared with \$3.9 million during the same period in 2018. This decrease was primarily driven by a \$43.7 million decrease in accounts payable and accrued liabilities and a \$10.4 million decrease in Billings in excess of costs and estimated earnings driven by timing of payments and project billings. These decreases were substantially offset by a \$41.8 million decrease in receivables, net and a \$6.5 million change in Other long-term liabilities. The change in Other long-term liabilities was primarily the result of the resolution of an uncertain tax position in the first quarter of 2018.

*Cash Used in Investing Activities*—During the first three months of 2019, cash used in investing activities was \$9.8 million compared to \$11.9 million during the same period in 2018. The \$2.1 million decrease in cash used primarily relates to cash paid (net of cash acquired) for acquisitions, partially offset by increased capital expenditures in 2019 compared to the same period in 2018.

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*Cash Used in Financing Activities*—Cash used in financing activities was \$7.7 million for the first three months of 2019 compared to \$3.2 million during the same period in 2018. The \$4.4 million increase in cash used is primarily due to \$4.0 million less in net proceeds from the revolving line of credit compared to the prior year.

*Free Cash Flow*—We define free cash flow as cash provided by operating activities, less customary capital expenditures, plus the proceeds from asset sales. We believe free cash flow, by encompassing both profit margins and the use of working capital over our approximately one year working capital cycle, is an effective measure of operating effectiveness and efficiency. We have included free cash flow information here for this reason, and because we are often asked about it by third parties evaluating us. However, free cash flow is not considered under generally accepted accounting principles to be a primary measure of an entity’s financial results, and accordingly free cash flow should not be considered an alternative to operating income, net income, or amounts shown in our consolidated statements of cash flows as determined under generally accepted accounting principles. Free cash flow may be defined differently by other companies.

***Share Repurchase Program***

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On August 10, 2018, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.7 million shares. Since the inception of the repurchase program, the Board has approved 8.8 million shares to be repurchased. As of March 31, 2019, we have repurchased a cumulative total of 8.3 million shares at an average price of \$16.51 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. During the three months ended March 31, 2019, we repurchased 0.1 million shares for approximately \$3.3 million at an average price of \$49.27 per share.

***Debt***

***Revolving Credit Facility***

On April 18, 2018, we amended our senior credit facility (the “Facility”) provided by a syndicate of banks, increasing our borrowing capacity from \$325.0 million to \$400.0 million, with a \$100 million accordion option. The Facility, which is available for borrowings and letters of credit, expires in April 2023 and is secured by a first lien on substantially all of our personal property except for assets related to projects subject to surety bonds and assets held by certain unrestricted subsidiaries and a second lien on our assets related to projects subject to surety bonds. As of March 31, 2019, we had \$51.0 million of outstanding borrowings, \$33.6 million in letters of credit outstanding and \$315.4 million of credit available.

There are two interest rate options for borrowings under the Facility, the Base Rate Loan Option and the Eurodollar Rate Loan Option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. Our lenders issue such letters of credit through the Facility for a fee. We have never had a claim made against a letter of credit that resulted in payments by a lender or by us and believe such a claim is unlikely in the foreseeable future. The letter of credit fees range from 1.25% to 2.00% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

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Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20% to 0.35% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA, as defined in the credit agreement.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. Covenant compliance is assessed as of each quarter end.

The Facility's principal financial covenants include:

*Total Leverage Ratio*—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed 3.00 to 1.00 as of the end of each fiscal quarter. The total leverage ratio as of March 31, 2019 was 0.4.

*Fixed Charge Coverage Ratio*—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, provision for income taxes, dividends and amounts used to repurchase stock to (b) the sum of interest expense and scheduled principal payments of indebtedness be at least 2.00 to 1.00; provided that the calculation of the fixed charge coverage ratio excludes stock repurchases and the payment of dividends at any time that the Company's Net Leverage Ratio, as defined in the credit agreement, does not exceed 1.75 to 1.00. The Facility also allows the fixed charge coverage ratio not to be reduced for stock repurchases made after the effective date of the Facility in an aggregate amount not to exceed \$30 million, if at the time of and after giving effect to such repurchase the Company's Net Leverage Ratio was less than or equal to 1.75 to 1.00. Credit Facility Adjusted EBITDA, capital expenditures, provision for income taxes, dividends, stock repurchase payments, interest expense, and scheduled principal payments are defined under the Facility for purposes of this covenant to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of March 31, 2019 was 22.6.

*Other Restrictions*—The Facility permits acquisitions of up to \$40.0 million per transaction, provided that the aggregate purchase price of all such acquisitions in the same fiscal year does not exceed \$80.0 million. However, these limitations only apply when the Company's Total Leverage Ratio is greater than 2.00 to 1.00.

While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility's leverage ratio covenant, our borrowing capacity under the Facility and the favorable terms that we currently have could be negatively impacted by the lenders.

We were in compliance with all of our financial covenants as of March 31, 2019.

*Notes to Former Owners*

As part of the consideration used to acquire six companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$26.2 million as of March 31, 2019. In conjunction with an acquisition in the first quarter of 2019, we issued a promissory note to former owners with an outstanding balance of \$0.4 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in January 2021. In conjunction with an acquisition in the third quarter of 2018, we issued a promissory note to former owners with an outstanding balance of \$6.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.5%. The principal is due in three equal installments in July 2019, 2020 and 2021. In conjunction with a separate acquisition in the third quarter of 2018, we issued a promissory note to former owners with an outstanding balance of \$3.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 2.9%. The principal is due in September 2020. In conjunction with a small acquisition in the second quarter of 2018, we issued a subordinated note to former owners with an outstanding balance of \$1.0 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.5%. The principal is due in equal installments in May 2020 and 2021. In conjunction with a small acquisition in the first quarter of 2018, we issued a subordinated note to former owners with an outstanding balance of \$0.5 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in January 2020. In conjunction with the BCH acquisition in the second quarter of 2017, we issued a promissory note to the former owners with an

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outstanding balance of \$14.3 million as of March 31, 2019 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in equal installments in April 2020 and 2021.

### *Other Debt*

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principal and interest due the last day of every month; ending on the December 30, 2019 maturity date. The interest rate is the one month LIBOR rate plus 2.25%. As of March 31, 2019, \$0.1 million of the note was outstanding, all of which was considered current.

### *Outlook*

We have generated positive net free cash flow for the last twenty calendar years, much of which occurred during challenging economic and industry conditions. We also continue to have significant borrowing capacity under our credit facility, and we maintain what we feel are reasonable cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

### **Off-Balance Sheet Arrangements and Other Commitments**

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. The letters of credit we provide are actually issued by our lenders through the Facility as described above. A letter of credit commits the lenders to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, we would be required to reimburse the lenders. Depending on the circumstances of such a reimbursement, we may also have to record a charge to earnings for the reimbursement. Absent a claim, there is no payment or reserving of funds by us in connection with a letter of credit. However, because a claim on a letter of credit would require immediate reimbursement by us to our lenders, letters of credit are treated as a use of the Facility's capacity just the same as actual borrowings. Claims against letters of credit are rare in our industry. To date we have not had a claim made against a letter of credit that resulted in payments by a lender or by us. We believe that it is unlikely that we will have to fund claims under a letter of credit in the foreseeable future.

Many customers, particularly in connection with new construction, require us to post performance and payment bonds issued by a financial institution known as a surety. If we fail to perform under the terms of a contract or to pay



subcontractors and vendors who provided goods or services under a contract, the customer may demand that the surety make payments or provide services under the bond. We must reimburse the sureties for any expenses or outlays they incur. To date, we are not aware of any losses to our sureties in connection with bonds the sureties have posted on our behalf, and we do not expect such losses to be incurred in the foreseeable future.

Under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 20% to 30% of our business has required bonds. While we currently have strong surety relationships to support our bonding needs, future market conditions or changes in our sureties' assessment of our operating and financial risk could cause our sureties to decline to issue bonds for our work. If that were to occur, our alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenue and profits to decline in the near term.

### **Contractual Obligations**

As of March 31, 2019, we have \$33.6 million in letter of credit commitments, of which \$11.3 million will expire in 2019 and \$22.3 million will expire in 2020. The substantial majority of these letters of credit are posted with

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insurers who disburse funds on our behalf in connection with our workers' compensation, auto liability and general liability insurance program. These letters of credit provide additional security to the insurers that sufficient financial resources will be available to fund claims on our behalf, many of which develop over long periods of time, should we ever encounter financial duress. Posting of letters of credit for this purpose is a common practice for entities that manage their self-insurance programs through third-party insurers as we do. While many of these letter of credit commitments expire in 2019, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually.

**Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

We are exposed to market risk primarily related to potential adverse changes in interest rates as discussed below. We are actively involved in monitoring exposure to market risk and continue to develop and utilize appropriate risk management techniques. We are not exposed to any other significant financial market risks including commodity price risk, foreign currency exchange risk or interest rate risks from the use of derivative financial instruments. We do not use derivative financial instruments.

We have exposure to changes in interest rates under our revolving credit facility. We have a modest level of indebtedness under our debt facility and our indebtedness could increase in the future. Our debt with fixed interest rates consists of notes to former owners of acquired companies.

The weighted average interest rate applicable to the borrowings under the Facility was approximately 3.7% as of March 31, 2019.

We measure certain assets at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. We did not recognize any impairments in the current year on those assets required to be measured at fair value on a nonrecurring basis.

The valuation of our contingent earn-out payments is determined using a probability weighted discounted cash flow method. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payment, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate.

**Item 4. *Controls and Procedures***

## **Evaluation of Disclosure Controls and Procedures**

Our executive management is responsible for ensuring the effectiveness of the design and operation of our disclosure controls and procedures. We carried out an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) are effective as of the end of the period covered by this report.

## **Changes in Internal Control over Financial Reporting**

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the three months ended March 31, 2019 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II—OTHER INFORMATION**

**Item 1. *Legal Proceedings***

We are subject to certain claims and lawsuits arising in the normal course of business. We maintain various insurance coverages to minimize financial risk associated with these claims. We have estimated and provided accruals for probable losses and related legal fees associated with certain litigation in our consolidated financial statements. While we cannot predict the outcome of these proceedings, in our opinion and based on reports of counsel, any liability arising from these matters individually and in the aggregate will not have a material effect on our operating results, cash flows or financial condition, after giving effect to provisions already recorded.

**Item 1A. *Risk Factors***

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part 1, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2018, which could materially affect our business, financial condition, or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, or future results.

**Item 2. *Unregistered Sales of Equity Securities and Use of Proceeds***

**Recent Sales of Unregistered Securities**

None.

**Issuer Purchases of Equity Securities**

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On August 10, 2018, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.7

million shares. Since the inception of the repurchase program, the Board has approved 8.8 million shares to be repurchased. As of March 31, 2019, we have repurchased a cumulative total of 8.3 million shares at an average price of \$16.51 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. The Board may modify, suspend, extend or terminate the program at any time. During the three months ended March 31, 2019, we repurchased 0.1 million shares for approximately \$3.3 million at an average price of \$49.27 per share.

During the quarter ended March 31, 2019, we purchased our common shares in the following amounts at the following average prices:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 1 - January 31	24,000	\$ 43.28	8,222,427	560,982
February 1 - February 28	—	\$ —	8,222,427	560,982
March 1 - March 31	43,394	\$ 52.58	8,265,821	517,588
	67,394	\$ 49.27	8,265,821	517,588

Under our 2012 Equity Incentive Plan and 2017 Omnibus Incentive Plan, employees may elect to have us withhold common shares to satisfy statutory federal, state and local tax withholding obligations arising on the vesting of restricted stock awards and exercise of options. When we withhold these shares, we are required to remit to the

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appropriate taxing authorities the market price of the shares withheld, which could be deemed a purchase of the common shares by us on the date of withholding.

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<b>Exhibit Number</b>	<b>Description of Exhibits</b>	<b>Exhibit Number</b>	<b>Filing or File Number</b>
			<b>Incorporated by Reference to the Exhibit Indicated Below and to the Filing with the Commission Indicated Below</b>
2.1	<u>Purchase Agreement, dated February 21, 2019, by and among the Company, Walker, the Shareholder Sellers and Scott Walker, in his capacity as representative of the Shareholder Sellers</u>	2.1	February 26, 2019  Form 8-K
3.1	<u>Second Amended and Restated Certificate of Incorporation of the Registrant</u>	3.1	333-24021
3.2	<u>Certificate of Amendment dated May 21, 1998</u>	3.2	1998 Form 10-K
3.3	<u>Certificate of Amendment dated July 9, 2003</u>	3.3	2003 Form 10-K
3.4	<u>Certificate of Amendment dated May 20, 2016</u>	3.1	May 20, 2016  Form 8-K
3.5	<u>Amended and Restated Bylaws of Comfort Systems USA, Inc.</u>	3.1	March 25, 2016 Form 8-K
31.1	<u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>		Filed Herewith
31.2	<u>Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u>		Filed Herewith
32.1	<u>Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>		Furnished Herewith
32.2	<u>Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002</u>		Furnished Herewith
101.INS	XBRL Instance Document		
101.SCH	XBRL Taxonomy Extension Schema Document		
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document		
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document		
101.LAB	XBRL Taxonomy Extension Label Linkbase Document		
101.PRE	XBRL Taxonomy Extension Presentation Linkbase		





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**SIGNATURES**

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

Comfort Systems USA, Inc.

April 25, 2019 By: /s/ Brian E. Lane

Brian E. Lane

*President, Chief Executive Officer and Director*

April 25, 2019 By: /s/ William George

William George

*Executive Vice President and Chief Financial Officer*

April 25, 2019 By: /s/ Julie S. Shaeff

Julie S. Shaeff

*Senior Vice President and Chief Accounting Officer*