

COMFORT SYSTEMS USA INC  
Form 10-Q  
July 27, 2017  
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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 June 30, 2017

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files). Yes No

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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<br>(Do not check if a<br>smaller reporting<br>company) | Smaller reporting<br>company | Emerging growth<br>company |
|-------------------------|-------------------|--|------------------------------|----------------------------|

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

Indicate by check mark whether the registrant 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 July 20, 2017 was 37,287,630 (excluding treasury shares of 3,835,735).

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COMFORT SYSTEMS USA, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts)

|   | June 30,<br>2017<br>(Unaudited) | December<br>31,<br>2016 |
|---|---------------------------------|-------------------------|
| <b>ASSETS</b>   |                                 |                         |
| <b>CURRENT ASSETS:</b>  |                                 |                         |
| Cash and cash equivalents   | \$ 34,465                       | \$ 32,074               |
| Accounts receivable, less allowance for doubtful accounts of \$4,715 and \$4,288, respectively                | 391,536                         | 318,837                 |
| Other receivables   | 14,333                          | 20,363                  |
| Inventories   | 10,571                          | 9,208                   |
| Prepaid expenses and other  | 5,611                           | 6,106                   |
| Costs and estimated earnings in excess of billings  | 40,653                          | 29,369                  |
| Total current assets  | 497,169                         | 415,957                 |
| PROPERTY AND EQUIPMENT, NET   | 74,539                          | 68,195                  |
| GOODWILL  | 203,223                         | 149,208                 |
| IDENTIFIABLE INTANGIBLE ASSETS, NET   | 83,269                          | 42,435                  |
| DEFERRED INCOME TAX ASSETS  | 29,717                          | 27,170                  |
| OTHER NONCURRENT ASSETS   | 5,238                           | 5,938                   |
| Total assets  | \$ 893,155                      | \$ 708,903              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |                                 |                         |
| <b>CURRENT LIABILITIES:</b>   |                                 |                         |
| Current maturities of long-term debt  | \$ 1,113                        | \$ 600                  |
| Current maturities of long-term capital lease obligations   | 112                             | 163                     |
| Accounts payable  | 124,326                         | 103,440                 |
| Accrued compensation and benefits   | 59,857                          | 61,712                  |
| Billings in excess of costs and estimated earnings  | 99,536                          | 83,985                  |
| Accrued self-insurance  | 34,987                          | 33,520                  |
| Other current liabilities   | 55,485                          | 34,261                  |
| Total current liabilities   | 375,416                         | 317,681                 |
| LONG-TERM DEBT  | 103,468                         | 1,955                   |
| LONG-TERM CAPITAL LEASE OBLIGATIONS   | 45                              | 93                      |
| DEFERRED INCOME TAX LIABILITIES   | 2,289                           | 2,289                   |
| OTHER LONG-TERM LIABILITIES   | 15,025                          | 10,252                  |
| Total liabilities   | 496,243                         | 332,270                 |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |                                 |                         |
| <b>STOCKHOLDERS' EQUITY:</b>  |                                 |                         |
| 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, 3,835,735 and 3,914,251 shares, respectively   | (59,219)                        | (57,387)                |
| Additional paid-in capital  | 311,692                         | 309,625                 |

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|  |            |            |
|--|------------|------------|
| Retained earnings                          | 144,028    | 123,984    |
| Total stockholders' equity                 | 396,912    | 376,633    |
| Total liabilities and stockholders' equity | \$ 893,155 | \$ 708,903 |

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

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COMFORT SYSTEMS USA, INC.

## CONSOLIDATED STATEMENTS OF OPERATIONS

(In Thousands, Except Per Share Data)

(Unaudited)

|   | Three Months Ended |            | Six Months Ended |            |
|---|--------------------|------------|------------------|------------|
|   | June 30,<br>2017   | 2016       | June 30,<br>2017 | 2016       |
| REVENUE   | \$ 465,411         | \$ 427,538 | \$ 845,999       | \$ 813,480 |
| COST OF SERVICES  | 369,673            | 338,112    | 674,307          | 650,552    |
| Gross profit  | 95,738             | 89,426     | 171,692          | 162,928    |
| SELLING, GENERAL AND ADMINISTRATIVE<br>EXPENSES                 | 66,599             | 61,023     | 129,846          | 119,213    |
| GOODWILL IMPAIRMENT   | —                  | —          | 1,105            | —          |
| GAIN ON SALE OF ASSETS  | (126)              | (212)      | (280)            | (357)      |
| Operating income  | 29,265             | 28,615     | 41,021           | 44,072     |
| OTHER INCOME (EXPENSE):   |                    |            |                  |            |
| Interest income   | 28                 | 2          | 39               | 3          |
| Interest expense  | (1,041)            | (606)      | (1,431)          | (1,307)    |
| Changes in the fair value of contingent earn-out<br>obligations | (598)              | (336)      | (624)            | (336)      |
| Other   | 29                 | (111)      | 47               | 375        |
| Other income (expense)  | (1,582)            | (1,051)    | (1,969)          | (1,265)    |
| INCOME BEFORE INCOME TAXES                                      | 27,683             | 27,564     | 39,052           | 42,807     |
| INCOME TAX EXPENSE  | 9,711              | 9,847      | 13,603           | 15,249     |
| NET INCOME  | \$ 17,972          | \$ 17,717  | \$ 25,449        | \$ 27,558  |
| INCOME PER SHARE:   |                    |            |                  |            |
| Basic   | \$ 0.48            | \$ 0.47    | \$ 0.68          | \$ 0.74    |
| Diluted   | \$ 0.48            | \$ 0.47    | \$ 0.67          | \$ 0.73    |
| SHARES USED IN COMPUTING INCOME PER<br>SHARE:                   |                    |            |                  |            |
| Basic   | 37,296             | 37,437     | 37,272           | 37,390     |
| Diluted   | 37,705             | 37,911     | 37,714           | 37,870     |
| DIVIDENDS PER SHARE   | \$ 0.075           | \$ 0.070   | \$ 0.145         | \$ 0.135   |

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

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COMFORT SYSTEMS USA, INC.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(In Thousands, Except Share Amounts)

|  | Common Stock<br>Shares | Common Stock<br>Amount | Treasury Stock<br>Shares | Treasury Stock<br>Amount | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Non-<br>Controlling<br>Interests | Total<br>Stockholders'<br>Equity |
|--|------------------------|------------------------|--------------------------|--------------------------|----------------------------------|----------------------|----------------------------------|----------------------------------|
| BALANCE<br>AT<br>DECEMBER<br>31, 2015  | 41,123,365             | \$ 411                 | (3,696,781)              | \$ (46,845)              | \$ 323,765                       | \$ 69,390            | \$ 18,284                        | \$ 365,005                       |
| Cumulative<br>effect of<br>change in<br>accounting<br>principle  | —                      | —                      | —                        | —                        | —                                | (38)                 | —                                | (38)                             |
| Net income   | —                      | —                      | —                        | —                        | —                                | 64,896               | —                                | 64,896                           |
| Issuance of<br>Stock:  |                        |                        |                          |                          |                                  |                      |                                  |                                  |
| Issuance of<br>shares for<br>options<br>exercised  | —                      | —                      | 111,761                  | 1,568                    | 10                               | —                    | —                                | 1,578                            |
| Issuance of<br>restricted stock<br>& performance<br>stock<br>Shares<br>received in lieu<br>of tax<br>withholding<br>payment on<br>vested<br>restricted stock | —                      | —                      | 172,727                  | 2,282                    | (306)                            | —                    | —                                | 1,976                            |
| Stock-based<br>compensation  | —                      | —                      | —                        | —                        | 3,502                            | —                    | —                                | 3,502                            |
| Dividends  | —                      | —                      | —                        | —                        | —                                | (10,264)             | —                                | (10,264)                         |
| Acquisition of<br>noncontrolling<br>interest   | —                      | —                      | —                        | —                        | (17,346)                         | —                    | (18,284)                         | (35,630)                         |
| Share<br>repurchase  | —                      | —                      | (460,170)                | (13,088)                 | —                                | —                    | —                                | (13,088)                         |
| BALANCE<br>AT<br>DECEMBER<br>31, 2016  | 41,123,365             | 411                    | (3,914,251)              | (57,387)                 | 309,625                          | 123,984              | —                                | 376,633                          |

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|  |            |        |             |             |            |            |      |            |
|--|------------|--------|-------------|-------------|------------|------------|------|------------|
| Net income<br>(unaudited)  | —          | —      | —           | —           | —          | 25,449     | —    | 25,449     |
| Issuance of<br>Stock:  |            |        |             |             |            |            |      |            |
| Issuance of<br>shares for<br>options<br>exercised<br>(unaudited)   | —          | —      | 90,498      | 1,366       | (70)       | —          | —    | 1,296      |
| Issuance of<br>restricted stock<br>& performance<br>stock<br>(unaudited)                                       | —          | —      | 134,646     | 2,037       | (421)      | —          | —    | 1,616      |
| Shares<br>received in lieu<br>of tax<br>withholding<br>payment on<br>vested<br>restricted stock<br>(unaudited) | —          | —      | (39,335)    | (1,419)     | —          | —          | —    | (1,419)    |
| Stock-based<br>compensation<br>(unaudited)   | —          | —      | —           | —           | 2,558      | —          | —    | 2,558      |
| Dividends<br>(unaudited)   | —          | —      | —           | —           | —          | (5,405)    | —    | (5,405)    |
| Share<br>repurchase<br>(unaudited)   | —          | —      | (107,293)   | (3,816)     | —          | —          | —    | (3,816)    |
| BALANCE<br>AT JUNE 30,<br>2017<br>(unaudited)  | 41,123,365 | \$ 411 | (3,835,735) | \$ (59,219) | \$ 311,692 | \$ 144,028 | \$ — | \$ 396,912 |

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



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COMFORT SYSTEMS USA, INC.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(In Thousands)

(Unaudited)

|   | Six Months Ended |           |
|---|------------------|-----------|
|   | June 30,         |           |
|   | 2017             | 2016      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                  |           |
| Net income  | \$ 25,449        | \$ 27,558 |
| Adjustments to reconcile net income to net cash provided by operating activities—             |                  |           |
| Amortization of identifiable intangible assets  | 7,302            | 4,190     |
| Depreciation expense  | 9,597            | 8,968     |
| Goodwill impairment   | 1,105            | —         |
| Bad debt expense (benefit)  | (62)             | (297)     |
| Deferred tax benefit  | (2,547)          | (162)     |
| Amortization of debt financing costs  | 188              | 179       |
| Gain on sale of assets  | (280)            | (357)     |
| Changes in the fair value of contingent earn-out obligations                                  | 624              | 336       |
| Stock-based compensation  | 3,447            | 3,349     |
| Changes in operating assets and liabilities, net of effects of acquisitions and divestitures— |                  |           |
| (Increase) decrease in—   |                  |           |
| Receivables, net  | (38,886)         | (6,684)   |
| Inventories   | (924)            | (532)     |
| Prepaid expenses and other current assets   | 4,043            | (1,649)   |
| Costs and estimated earnings in excess of billings  | (8,781)          | (1,239)   |
| Other noncurrent assets   | 420              | (84)      |
| Increase (decrease) in—   |                  |           |
| Accounts payable and accrued liabilities  | 13,422           | 6,429     |
| Billings in excess of costs and estimated earnings  | 6,835            | (4,220)   |
| Other long-term liabilities   | 228              | 636       |
| Net cash provided by operating activities   | 21,180           | 36,421    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                  |           |
| Purchases of property and equipment   | (11,646)         | (10,904)  |
| Proceeds from sales of property and equipment   | 605              | 494       |
| Cash paid for acquisitions, net of cash acquired  | (83,710)         | (58,490)  |
| Net cash used in investing activities   | (94,751)         | (68,900)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                  |           |
| Proceeds from revolving line of credit  | 110,000          | 138,000   |
| Payments on revolving line of credit  | (21,500)         | (112,000) |
| Payments on other debt  | (287)            | (42)      |
| Payments on capital lease obligations   | (105)            | (133)     |
| Debt financing costs  | —                | (789)     |
| Payments of dividends to stockholders   | (5,405)          | (5,044)   |

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|  |           |           |
|--|-----------|-----------|
| Share repurchase                                     | (3,816)   | (4,924)   |
| Shares received in lieu of tax withholding           | (1,419)   | (1,304)   |
| Proceeds from exercise of options                    | 1,296     | 733       |
| Deferred acquisition payments                        | (2,802)   | —         |
| Payments for contingent consideration arrangements   | —         | (200)     |
| Net cash provided by financing activities            | 75,962    | 14,297    |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | 2,391     | (18,182)  |
| CASH AND CASH EQUIVALENTS, beginning of period       | 32,074    | 56,464    |
| CASH AND CASH EQUIVALENTS, end of period             | \$ 34,465 | \$ 38,282 |

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

June 30, 2017

(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 39% of our consolidated 2017 revenue is attributable to installation of systems in newly constructed facilities, with the remaining 61% attributable to maintenance, repair and replacement services.

Our consolidated 2017 revenue was derived from the following service activities, all of which are in the mechanical services industry, the single industry segment we serve:

| Service Activity                    | Revenue         |       |
|-------------------------------------|-----------------|-------|
|                                     | \$ in thousands | %     |
| HVAC and Plumbing                   | \$ 761,399      | 90 %  |
| Building Automation Control Systems | 50,760          | 6 %   |
| Other                               | 33,840          | 4 %   |
| Total                               | \$ 845,999      | 100 % |

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, 2016 (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.

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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09 provides a framework that replaces the existing revenue recognition guidance. The guidance can be applied on a full retrospective or modified retrospective basis whereby the entity records a cumulative effect of initially applying this update on the adoption date. We plan to use the modified retrospective basis on the adoption date. ASU 2014-09 is effective for annual periods beginning after December 15, 2017, including interim periods within that reporting period. While we are still evaluating the potential impact of this authoritative guidance on our consolidated financial statements, we currently believe the areas that may impact us the most include accounting for variable consideration, capitalization of incremental costs of obtaining a contract and the guidance on the number of performance obligations contained in a contract. The impact on our consolidated financial statements upon adoption of ASU 2014-09 will be determined in large part by the contracts in progress on our adoption date; however, we currently do not believe the adoption will have a material impact on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)”. The standard requires lessees to recognize assets and liabilities for most leases. ASU 2016-02 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2018. Early adoption is permitted. ASU 2016-02’s transition provisions are applied using a modified retrospective approach at the beginning of the earliest comparative period presented in the financial statements. Full retrospective application is prohibited. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”. This standard provides guidance on how certain cash receipts and cash payments are presented and classified in the statement of cash flows and is intended to reduce diversity in practice with respect to these items. The standard is applied using a retrospective transition method and is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and other (Topic 350): Simplifying the Accounting for Goodwill Impairment”. This standard removes Step 2 of the goodwill impairment test, which required a hypothetical purchase price allocation. A goodwill impairment will be the amount by which a reporting unit’s carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. Additionally, entities will be required to disclose the amount of goodwill at reporting units with zero or negative carrying amounts. The standard is applied prospectively and is effective for fiscal years beginning after December 15, 2019, including annual or interim goodwill impairment tests within those fiscal years. Early adoption is permitted for interim and annual goodwill impairment tests performed on testing dates after January 1, 2017. We early adopted ASU 2017-04 in the first quarter of 2017, which did not have a material impact on our consolidated financial statements.

## Financial Instruments

Our financial instruments consist of cash and cash equivalents, accounts receivable, other receivables, accounts payable, life insurance policies, notes to former owners, capital 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.

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## 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.

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 June 30, 2017 (in thousands):

|                                     | Balance<br>June 30,<br>2017 | Fair Value Measurements at<br>Reporting Date |          |           |
|-------------------------------------|-----------------------------|--|----------|-----------|
|                                     |                             | Level 1                                      | Level 2  | Level 3   |
| Cash and cash equivalents           | \$ 34,465                   | \$ 34,465                                    | \$ —     | \$ —      |
| Life insurance—cash surrender value | \$ 3,501                    | \$ —   | \$ 3,501 | \$ —      |
| Contingent earn-out obligations     | \$ 14,910                   | \$ —   | \$ —     | \$ 14,910 |

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.

One of our operations has life insurance policies covering 46 employees with a combined face value of \$41.4 million. The policy is invested in mutual funds 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 \$3.5 million as of June 30, 2017 and \$3.7 million as of December 31, 2016. 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 | \$ 2,531  |
| Issuances                    | 11,755    |
| Settlements                  | —         |
| Adjustments to fair value    | 624       |
| Balance at June 30, 2017     | \$ 14,910 |

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. During the first quarter of 2017, we recorded a goodwill impairment charge of \$1.1 million based on Level 3 measurements. See Note 5 “Goodwill” for further discussion. We did not recognize any other impairments, in the first six months of 2017, on those assets required to be measured at fair value on a nonrecurring basis.



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4. Acquisitions

On April 1, 2017, we acquired all of the issued and outstanding stock of BCH Holdings, Inc. and each of its wholly-owned subsidiaries (collectively “BCH”) for \$100 million, comprised of \$85.7 million in cash at closing and \$14.3 million in a note payable to the former owners, plus an earn out that we will pay if certain financial targets are met after the acquisition date and a working capital adjustment. The preliminary acquisition date fair value of consideration transferred for this acquisition was \$122.6 million, of which \$97.9 million was allocated to goodwill and identifiable intangible assets. BCH is an integrated, single-source provider of mechanical service, maintenance and construction with headquarters in Tampa, Florida and operations throughout the southeastern region of the United States, which included revenue of \$38.6 million and reports as a separate operating location.

We completed two acquisitions in the first quarter of 2016. We acquired the remaining 40% noncontrolling interest in Environmental Air Systems, LLC (“EAS”) on January 1, 2016 for \$46.6 million, including \$42.0 million funded on the closing date plus a holdback, an earn-out that will be earned if certain financial targets are met after the acquisition date and a working capital adjustment. Due to our majority ownership and control over EAS on the acquisition date, the difference between the purchase price and the noncontrolling interest liability was recorded in Additional Paid-In Capital in our Balance Sheet.

Additionally in the first quarter of 2016, we acquired 100% of the ShoffnerKalthoff family of companies (collectively, “Shoffner”), which reports as a separate operating location in the Knoxville, Tennessee area. The acquisition date fair value of consideration transferred for this acquisition was \$19.8 million, of which \$14.8 million was allocated to goodwill and identifiable intangible assets. The purchase price included \$15.5 million funded on the closing date plus a note payable to the former owners, an earn-out that we will pay if certain financial targets are met after the acquisition date and a working capital adjustment.

In addition to the BCH acquisition, we completed three additional acquisitions in the second quarter of 2017. The total purchase price for these acquisitions, including earn-outs, was \$7.8 million for the six months ended June 30, 2017. These acquisitions were not material and were “tucked-in” with existing operations.

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 acquisition 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 are not subject to the continued employment of the sellers.

## 5. Goodwill

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

|                              | June 30,<br>2017 | December<br>31,<br>2016 |
|------------------------------|------------------|-------------------------|
| Balance at beginning of year | \$ 149,208       | \$ 143,874              |
| Additions (See Note 4)       | 55,120           | 5,334                   |
| Impairment adjustment        | (1,105)          | —                       |
| Balance at end of period     | \$ 203,223       | \$ 149,208              |

We recorded a goodwill impairment charge of \$1.1 million during the first quarter of 2017. Based on changes to our market strategy that occurred in March 2017 related to our reporting unit based in California, we reevaluated our projected future earnings for this operating location. When the carrying value of a given reporting unit exceeds its fair value, a goodwill impairment loss is recorded for this difference, not to exceed the carrying amount of goodwill. Based upon our projected future earnings for this location, we could no longer support the related goodwill balance and

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therefore the goodwill associated with this location was fully impaired. The fair value was estimated using a discounted cash flow model.

## 6. Debt Obligations

Debt obligations consist of the following (in thousands):

|                                 | June 30,<br>2017 | December<br>31,<br>2016 |
|---------------------------------|------------------|-------------------------|
| Revolving credit facility       | \$ 88,500        | \$ —                    |
| Notes to former owners          | 15,825           | 2,250                   |
| Other debt                      | 256              | 305                     |
| Capital lease obligations       | 157              | 256                     |
| Total debt                      | 104,738          | 2,811                   |
| Less—current portion            | (1,225)          | (763)                   |
| Total long-term portion of debt | \$ 103,513       | \$ 2,048                |

## Revolving Credit Facility

We have a \$325.0 million senior credit facility (the “Facility”) provided by a syndicate of banks, with a \$100 million accordion option. The Facility, which is available for borrowings and letters of credit, expires in February 2021 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 June 30, 2017, we had \$88.5 million of outstanding borrowings, \$39.6 million in letters of credit outstanding and \$196.9 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.

The following is a summary of the additional margins:

|  | Consolidated Total Indebtedness to<br>Credit Facility Adjusted EBITDA |              |              |                 |        |        |        |        |
|--|---|--------------|--------------|-----------------|--------|--------|--------|--------|
|  | Less than 0.75  | 0.75 to 1.50 | 1.50 to 2.25 | 2.25 or greater |        |        |        |        |
| Additional Per Annum Interest Margin<br>Added Under: |   |              |              |                 |        |        |        |        |
| Base Rate Loan Option                                | 0.25  | % 0.50       | % 0.75       | % 1.00          | % 1.50 | % 2.00 | % 2.25 | % 2.50 |
| Eurodollar Rate Loan Option                          | 1.25  | % 1.50       | % 1.75       | % 2.00          | % 2.25 | % 2.50 | % 2.75 | % 3.00 |

The weighted average interest rate applicable to the borrowings under the Facility was approximately 2.4% as of June 30, 2017.

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.

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.

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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:

**Leverage Ratio**—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed (i) 3.00 to 1.00 as of the end of each fiscal quarter through September 30, 2017, and (ii) 2.75 to 1.00 as of the end of each fiscal quarter thereafter through maturity. The leverage ratio as of June 30, 2017 was 0.70.

**Fixed Charge Coverage Ratio**—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, tax provision, 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 does not exceed 1.50 to 1.00. The Facility also allows the fixed charge coverage ratio not to be reduced for stock repurchases through September 30, 2015 in an aggregate amount not to exceed \$25 million and for stock repurchases made after February 22, 2016 but on or prior to December 31, 2017 in an aggregate amount not to exceed \$25 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 1.50 to 1.00. Capital expenditures, tax provision, dividends and stock repurchase 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 June 30, 2017 was 27.67.

**Other Restrictions**—The Facility permits acquisitions of up to \$30.0 million per transaction, provided that the aggregate purchase price of all such acquisitions in the same fiscal year does not exceed \$65.0 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 June 30, 2017.

Notes to Former Owners

As part of the consideration used to acquire three companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$15.8 million as of June 30, 2017. 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 June 30, 2017 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. In conjunction with the Shoffner acquisition in the first quarter of 2016, we issued a subordinated note to former owners with an outstanding balance of \$1.0 million as of June 30, 2017 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in equal installments in February 2018 and 2019. In conjunction with an acquisition in the fourth quarter of 2014, we issued a promissory note to the former owners with an outstanding balance of \$0.5 million as of June 30, 2017 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in October 2017.

#### Other Debt

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principle 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 June 30, 2017, \$0.3 million of the note was outstanding, of which \$0.1 million was considered current.

In addition, with one of our acquisitions we acquired capital lease obligations. As of June 30, 2017, \$0.2 million of capital lease obligations were outstanding, of which \$0.1 million was considered current.

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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.

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 no anti-dilutive stock options for the three months ended June 30, 2017 or for the three months ended June 30, 2016. There were no anti-dilutive stock options for the six months ended June 30, 2017 and approximately 0.1 million anti-dilutive stock options excluded from the calculation of diluted EPS for the six months ended June 30, 2016.

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):

|   | Three Months              |        | Six Months Ended |        |
|---|---------------------------|--------|------------------|--------|
|   | Ended<br>June 30,<br>2017 | 2016   | 2017             | 2016   |
| Common shares outstanding, end of period  | 37,288                    | 37,444 | 37,288           | 37,444 |
| Effect of using weighted average common shares outstanding                            | 8                         | (7)    | (16)             | (54)   |
| Shares used in computing earnings per share—basic                                     | 37,296                    | 37,437 | 37,272           | 37,390 |
| Effect of shares issuable under stock option plans based on the treasury stock method | 308                       | 351    | 321              | 336    |
| Effect of restricted and contingently issuable shares                                 | 101                       | 123    | 121              | 144    |
| Shares used in computing earnings per share—diluted                                   | 37,705                    | 37,911 | 37,714           | 37,870 |

## 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 approved extensions of the program to acquire additional shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of June 30, 2017, we have repurchased a cumulative total of 7.4 million shares at an average price of \$13.35 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 six months ended

June 30, 2017, we repurchased 0.1 million shares for approximately \$3.8 million at an average price of \$35.57 per share.

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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, 2016 (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 81% 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 June 30, 2017 we had 5,006 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$473,000. 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 June 30, 2017, by contract price, is as follows:

| Contract Price of Project   | No. of Projects | Aggregate Contract Price Value (millions) |
|-----------------------------|-----------------|---|
| Under \$1 million           | 4,513           | \$ 525.0                                  |
| \$1 million - \$5 million   | 392             | 871.8                                     |
| \$5 million - \$10 million  | 67              | 441.6                                     |
| \$10 million - \$15 million | 22              | 268.6                                     |
| Greater than \$15 million   | 12              | 262.6                                     |
| Total                       | 5,006           | \$ 2,369.6                                |

In addition to project work, approximately 19% 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 36 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 general 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 2015 and 2016, there was an increase in overall activity levels and we currently expect that activity will continue at these improved levels during 2017.

As a result of our continued strong emphasis on cash flow, at June 30, 2017 we had a strong financial position, as discussed further in “Liquidity and Capital Resources” below. We have a credit facility in place with considerably less

restrictive terms than those of our previous facilities; this facility does not expire until February 2021. 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 solid current results and financial position. We have generated positive free cash flow in each of the last eighteen calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our balance sheet and surety support 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 our efforts 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 2017 will be on execution and cost control, but we are seeking growth based on our belief that industry conditions will continue to be strong in 2017, and we believe that activity levels will permit us to earn improved 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.

#### Cyclical 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):

|  | Three Months Ended June 30, |         |            |         | Six Months Ended June 30, |         |            |         |
|--|-----------------------------|---------|------------|---------|---------------------------|---------|------------|---------|
|  | 2017                        |         | 2016       |         | 2017                      |         | 2016       |         |
| Revenue  | \$ 465,411                  | 100.0 % | \$ 427,538 | 100.0 % | \$ 845,999                | 100.0 % | \$ 813,480 | 100.0 % |
| Cost of services   | 369,673                     | 79.4 %  | 338,112    | 79.1 %  | 674,307                   | 79.7 %  | 650,552    | 80.0 %  |
| Gross profit   | 95,738                      | 20.6 %  | 89,426     | 20.9 %  | 171,692                   | 20.3 %  | 162,928    | 20.0 %  |
| Selling, general and administrative expenses                 | 66,599                      | 14.3 %  | 61,023     | 14.3 %  | 129,846                   | 15.3 %  | 119,213    | 14.7 %  |
| Goodwill impairment  | —                           | —       | —          | —       | 1,105                     | 0.1 %   | —          | —       |
| Gain on sale of assets                                       | (126)                       | —       | (212)      | —       | (280)                     | —       | (357)      | —       |
| Operating income   | 29,265                      | 6.3 %   | 28,615     | 6.7 %   | 41,021                    | 4.8 %   | 44,072     | 5.4 %   |
| Interest income  | 28                          | —       | 2          | —       | 39                        | —       | 3          | —       |
| Interest expense   | (1,041)                     | (0.2) % | (606)      | (0.1) % | (1,431)                   | (0.2) % | (1,307)    | (0.2) % |
| Changes in the fair value of contingent earn-out obligations | (598)                       | (0.1) % | (336)      | (0.1) % | (624)                     | (0.1) % | (336)      | —       |
| Other income (expense)                                       | 29                          | —       | (111)      | —       | 47                        | —       | 375        | —       |
| Income before income taxes                                   | 27,683                      | 5.9 %   | 27,564     | 6.4 %   | 39,052                    | 4.6 %   | 42,807     | 5.3 %   |
| Income tax expense   | 9,711                       |         | 9,847      |         | 13,603                    |         | 15,249     |         |
| Net income   | \$ 17,972                   | 3.9 %   | \$ 17,717  | 4.1 %   | \$ 25,449                 | 3.0 %   | \$ 27,558  | 3.4 %   |

We had 35 operating locations as of December 31, 2016. We completed one acquisition in the second quarter of 2017, known as “BCH”, that reports as a separate location in the Tampa, Florida area. We did not make any changes to operating locations during the first quarter. As of June 30, 2017, we had 36 operating locations. Acquisitions are included in our results of operations from the respective acquisition date. The same store comparison from 2017 to 2016, as described below, excludes the three months of results for BCH, which was acquired in April 2017 as well as the first month of 2017 for Shoffner, which was acquired in February 2016. An operating location is included in the same store comparison on the first day it has comparable prior year operating data. An operating location is excluded from the same store comparison in the current year and comparable prior years when it is properly characterized as a discontinued operation under applicable accounting standards.

Revenue—Revenue increased \$37.9 million, or 8.9%, to \$465.4 million for the second quarter of 2017 compared to the same period in 2016. The increase included a 9.0% increase related to the acquisition of BCH partially offset by a 0.1% decrease in revenue related to same store activity. The same store revenue decrease is primarily due to a decrease in activity at our North Carolina operation (\$6.3 million) and one of our Tennessee operations (\$5.0 million). This was partially offset by an increase at our New Hampshire operation (\$8.7 million).

Revenue increased \$32.5 million, or 4.0%, to \$846.0 million for the first six months of 2017 compared to the same period in 2016. The increase included a 5.5% increase related to the acquisitions of BCH and Shoffner partially offset by a 1.5% decrease in revenue related to same store activity. The same store revenue decrease is primarily due to a decrease in activity at our North Carolina operation (\$9.6 million) and one of our Virginia operations (\$6.1 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

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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 June 30, 2017 was \$937.8 million, an 8.7% increase from March 31, 2017 backlog of \$863.0 million, and a 29.5% increase from June 30, 2016 backlog of \$724.3 million. Sequential backlog increased primarily due to the acquisition of BCH (\$42.1 million or 4.9%). Additionally, same-store backlog increased due to increased project bookings at our Arizona operation (\$25.6 million) and one of our Texas operations (\$15.7 million). This was partially offset by a completion of project work at our New Hampshire operation (\$13.5 million). The year over year backlog increase included the acquisition of BCH (\$42.1 million) and a same-store increase of \$171.4 million or 23.7%. Same-store backlog increased primarily due to increased project bookings at one of our Virginia operations (\$54.9 million), our Colorado operation (\$30.1 million) and our Arizona operation (\$29.6 million).

Gross Profit—Gross profit increased \$6.3 million, or 7.1%, to \$95.7 million for the second quarter of 2017 as compared to the same period in 2016. The increase included a \$6.8 million, or 7.6%, increase related to the acquisition of BCH offset by a \$0.5 million, or 0.6%, decrease in same store activity. The same store decrease in gross profit was primarily due to lower project performance at our Arkansas operation (\$1.6 million) compared to the prior year. As a percentage of revenue, gross profit decreased from 20.9% in 2016 to 20.6% in 2017 primarily due to an increase in backlog amortization as a result of the BCH acquisition.

Gross profit increased \$8.8 million, or 5.4%, to \$171.7 million for the first six months of 2017 as compared to the same period in 2016. The increase included an \$8.4 million, or 5.2%, increase related to the acquisitions of BCH and Shoffner and a \$0.4 million, or 0.2%, increase in same store activity. The same store increase in gross profit was primarily due to the improvement in project execution at our Wisconsin operation (\$3.4 million). This was partially offset by a decrease due to job underperformance at our California operation (\$2.5 million). As a percentage of revenue, gross profit increased from 20.0% in 2016 to 20.3% in 2017 primarily due to the factors discussed above.

Selling, General and Administrative Expenses (“SG&A”)—SG&A increased \$5.6 million, or 9.1%, to \$66.6 million for the second quarter of 2017 as compared to 2016. On a same store basis, excluding amortization expense, SG&A increased \$0.4 million, or 0.7%. This increase is primarily due to increased compensation costs related to investments in service. Amortization expense increased \$1.7 million during the period as a result of the BCH acquisition. As a percentage of revenue, SG&A remained flat at 14.3% in both 2017 and 2016.

SG&A increased \$10.6 million, or 8.9%, to \$129.8 million for the first six months of 2017 as compared to 2016. On a same store basis, excluding amortization expense, SG&A increased \$4.8 million, or 4.1%. This increase is primarily due to \$0.8 million in compensation costs related to leadership changes, investments in service and an increase in bad debt expense of \$0.2 million due to the collection of aged receivables in the prior year period. Additionally, we incurred \$0.4 million in expenses in the first quarter of 2017 related to the acquisition of BCH completed on April 1,

2017. Amortization expense increased \$1.5 million during the period primarily as a result of the BCH acquisition. As a percentage of revenue, SG&A increased from 14.7% in 2016 to 15.3% in 2017 primarily due to the factors discussed above.

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

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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.

|   | Three Months Ended |           | Six Months Ended |            |
|---|--------------------|-----------|------------------|------------|
|   | June 30,<br>2017   | 2016      | June 30,<br>2017 | 2016       |
|   | (in thousands)     |           | (in thousands)   |            |
| SG&A  | \$ 66,599          | \$ 61,023 | \$ 129,846       | \$ 119,213 |
| Less: SG&A from companies acquired              | (3,443)            | —         | (4,331)          | —          |
| Less: Amortization expense                      | (3,283)            | (1,571)   | (4,678)          | (3,133)    |
| Same-store SG&A, excluding amortization expense | \$ 59,873          | \$ 59,452 | \$ 120,837       | \$ 116,080 |

**Goodwill Impairment**—We recorded a goodwill impairment charge of \$1.1 million during the first quarter of 2017. Based on changes to our market strategy that occurred in March 2017 related to our reporting unit based in California, we reevaluated our projected future earnings for this operating location. When the carrying value of a given reporting unit exceeds its fair value, a goodwill impairment loss is recorded for this difference, not to exceed the carrying amount of goodwill. Based upon our projected future earnings for this location, we could no longer support the related goodwill balance and therefore the goodwill associated with this location was fully impaired. The fair value was estimated using a discounted cash flow model.

**Interest Expense**—Interest expense increased \$0.4 million, or 71.8%, to \$1.0 million for the second quarter of 2017 as compared to the same period in 2016. Interest expense increased \$0.1 million, or 9.5%, to \$1.4 million for the first six months of 2017 as compared to the same period in 2016. The increase reflects the increased borrowings on the revolving credit facility as well as notes to former owners used to fund the BCH acquisition during the second quarter of 2017.

**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. Expense from changes in the fair value of contingent earn out obligations for the second quarter of 2017 increased \$0.3 million as compared to the same period in 2016. Based on updated measurements of estimated future cash flows for our contingent obligations, we increased our obligation related to the BCH acquisition resulting in an expense of \$0.6 million.

Expense from changes in the fair value of contingent earn out obligations for the first six months of 2017 increased \$0.3 million as compared to the same period in 2016. Based on updated measurements of estimated future cash flows for our contingent obligations, we increased our obligation related to the BCH acquisition resulting in an expense of \$0.6 million.

**Income Tax Expense**—We perform work throughout the United States in virtually all of the fifty states. Our effective tax rate varies based upon our relative profitability, or lack of profitability, in states with varying state tax rates and rules.

In addition, discrete events, judgments and legal structures can affect our effective tax rate. These items can include the tax treatment for impairment of goodwill and other intangible assets and changes in fair value of acquisition related assets and liabilities, tax reserves associated with regulatory audits, accounting for losses associated with underperforming operations and the partial ownership of consolidated entities.

For the six months ended June 30, 2017 our tax expense was \$13.6 million with an effective tax rate of 34.8% as compared to tax expense of \$15.2 million with an effective tax rate of 35.6% for the same period in 2016. The effective rate for 2017 was lower than the federal statutory rate of 35.0% primarily due to the benefits from deductions on stock compensation (2.4%) and the production activity deduction (2.3%) partially offset by state income taxes (3.7%) and non deductible expenses (0.9%). The effective rate for 2016 was higher than the federal statutory rate of 35.0% primarily due to state income taxes (3.9%) and non deductible expenses (0.8%) partially offset by the production activity deduction (2.1%), benefits from deductions on stock compensation (1.6%) and a decrease in valuation allowance (1.0%). Tax reserves are analyzed and adjusted quarterly as events occur to warrant such changes. Adjustments to tax reserves are a component of the effective tax rate. We currently estimate our effective tax rate for the full year of 2017 will be between 35% and 40%.

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## Outlook

We have seen industry conditions improve during 2015 and 2016. Our emphasis for 2017 is on execution, including a focus on cost discipline and efficient project performance, labor force development, and investing in growth, particularly in service and small projects. Based on our recent acquisitions, we expect that our 2017 revenues will be above levels we experienced in 2016. Additionally, in light of economic conditions for our industry, we expect that profitability in 2017 will continue to be strong and at levels similar to what we experienced in 2016.

## Liquidity and Capital Resources (in thousands):

|  | Six Months Ended |             |
|--|------------------|-------------|
|  | June 30,         |             |
|  | 2017             | 2016        |
| Cash provided by (used in):                          |                  |             |
| Operating activities                                 | \$ 21,180        | \$ 36,421   |
| Investing activities                                 | (94,751)         | (68,900)    |
| Financing activities                                 | 75,962           | 14,297      |
| Net increase (decrease) in cash and cash equivalents | \$ 2,391         | \$ (18,182) |
| Free cash flow:                                      |                  |             |
| Cash provided by operating activities                | \$ 21,180        | \$ 36,421   |
| Purchases of property and equipment                  | (11,646)         | (10,904)    |
| Proceeds from sales of property and equipment        | 605              | 494         |
| Free cash flow                                       | \$ 10,139        | \$ 26,011   |

## 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 \$21.2 million during the first six months of 2017 compared with \$36.4 million during the same period in 2016. The \$15.2 million decrease is primarily due to a \$32.2 million increase in receivables related to project work timing and the schedule for billings as well as the increase in revenue compared to the same period in 2016. This use of operating cash flow was partially offset by an increase in billings in excess of costs and estimated earnings of \$11.1 million and an increase in accounts payable and accrued liabilities of \$7.0 million, primarily due to the timing of billings and various project work.

Cash Used in Investing Activities—During the first six months of 2017, cash used in investing activities was \$94.8 million compared to \$68.9 million during the same period in 2016. The \$25.9 million increase in cash used primarily relates to cash paid (net of cash acquired) for the BCH acquisition in 2017 of \$76.1 million compared to the



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EAS and Shoffner acquisitions in 2016 (\$56.3 million). Additionally, there was a \$0.7 million increase in purchases of property and equipment primarily related to investments in vehicles.

**Cash Provided by Financing Activities**—Cash provided by financing activities was \$76.0 million for the first six months of 2017 compared to \$14.3 million during the same period in 2016. The \$61.7 million increase in cash provided by financing activities is primarily due to \$62.5 million of additional net proceeds from the revolving line of credit during the first six months of 2017.

**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 approved extensions of the program to acquire additional shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of June 30, 2017, we have repurchased a cumulative total of 7.4 million shares at an average price of \$13.35 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 six months ended June 30, 2017, we repurchased 0.1 million shares for approximately \$3.8 million at an average price of \$35.57 per share.

## Debt

## Revolving Credit Facility

We have a \$325.0 million senior credit facility (the “Facility”) provided by a syndicate of banks, with a \$100 million accordion option. The Facility, which is available for borrowings and letters of credit, expires in February 2021 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 June 30, 2017, we had \$88.5 million of outstanding borrowings, \$39.6 million in letters of credit outstanding and \$196.9 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:

**Leverage Ratio**—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed (i) 3.00 to 1.00 as of the end of each fiscal quarter through September 30, 2017, and (ii) 2.75 to 1.00 as of the end of each fiscal quarter thereafter through maturity. The leverage ratio as of June 30, 2017 was 0.70.

**Fixed Charge Coverage Ratio**—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, tax provision, 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 does not exceed 1.50 to 1.00. The Facility also allows the fixed charge coverage ratio not to be reduced for stock repurchases through September 30, 2015 in an aggregate amount not to exceed \$25 million and for stock repurchases made after February 22, 2016 but on or prior to December 31, 2017 in an aggregate amount not to exceed \$25 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 1.50 to 1.00. Capital expenditures, tax provision, dividends and stock repurchase 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 June 30, 2017 was 27.67.

**Other Restrictions**—The Facility permits acquisitions of up to \$30.0 million per transaction, provided that the aggregate purchase price of all such acquisitions in the same fiscal year does not exceed \$65.0 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 June 30, 2017.

#### Notes to Former Owners

As part of the consideration used to acquire three companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$15.8 million as of June 30, 2017. 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 June 30, 2017 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. In conjunction with the Shoffner acquisition in the first quarter of 2016, we issued a subordinated note to former owners with an outstanding balance of \$1.0 million as of June 30, 2017 that bears interest, payable quarterly, at a weighted average interest rate of 3.0%. The principal is due in equal installments in February 2018 and 2019. In conjunction with an acquisition in the fourth quarter of 2014, we issued a promissory note to the former owners with an outstanding balance of \$0.5 million as of June 30, 2017 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in October 2017.

#### Other Debt

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principle and interest due the last day of every month; ending on the December 30, 2019 maturity date. The

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interest rate is the one month LIBOR rate plus 2.25%. As of June 30, 2017, \$0.3 million of the note was outstanding, of which \$0.1 million was considered current.

In addition, with one of our acquisitions we acquired capital lease obligations. As of June 30, 2017, \$0.2 million of capital lease obligations were outstanding, of which \$0.1 million was considered current.

## Outlook

We have generated positive net free cash flow for the last eighteen 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

As is common in our industry, we have entered into certain off balance sheet arrangements in the ordinary course of business that result in risks not directly reflected in our balance sheets. Our most significant off balance sheet transactions include liabilities associated with noncancelable operating leases. We also have other off balance sheet obligations involving letters of credit and surety guarantees.

We enter into noncancelable operating leases for many of our facility, vehicle and equipment needs. These leases allow us to conserve cash by paying a monthly lease rental fee for use of facilities, vehicles and equipment rather than purchasing them. At the end of the lease, we have no further obligation to the lessor. 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.

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

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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 June 30, 2017, we have \$39.6 million in letter of credit commitments, of which \$11.3 million will expire in 2017 and \$28.3 million will expire in 2018. The substantial majority of these letters of credit are posted with 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 2017, 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 borrowings under the Facility was approximately 2.4% as of June 30, 2017.

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. During the first quarter of 2017 we recorded a goodwill impairment charge of \$1.1 million based on Level 3 measurements. See Note 5 "Goodwill" for further discussion. We

did not recognize any other impairments, in the first six months of 2017, 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.



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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 June 30, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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, 2016, 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 approved extensions of the program to acquire additional shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of June 30, 2017, we have repurchased a cumulative total of 7.4 million shares at an average price of \$13.35 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 six months ended June 30, 2017, we repurchased 0.1 million shares for approximately \$3.8 million at an average price of \$35.57 per share.

During the quarter ended June 30, 2017, we purchased our common shares in the following amounts at the following average prices:

| Period             | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------|----------------------------------|------------------------------|--|--|
| April 1 - April 30 | 500                              | \$ 34.73                     | 7,404,403  | 708,090  |
| May 1 - May 31     | 45,381                           | \$ 35.28                     | 7,449,784  | 662,709  |
| June 1 - June 30   | —                                | \$ —                         | 7,449,784  | 662,709  |
|                    | 45,881                           | \$ 35.28                     | 7,449,784  | 662,709  |

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## Item 6. Exhibits

|                   |  | Incorporated by Reference<br>to the Exhibit Indicated<br>Below<br>and to the Filing with the<br>Commission Indicated<br>Below |                            |
|-------------------|--|---|----------------------------|
| Exhibit<br>Number | Description of Exhibits  | Exhibit<br>Number   | Filing or<br>File Number   |
| 2.1               | <u>Stock Purchase Agreement, dated February 21, 2017, by and among the Company, BCH, the Selling Shareholders and Daryl Blume, in his capacity as representative of the Selling Shareholders</u> | 2.1   | February 23, 2017          |
| 3.1               | <u>Second Amended and Restated Certificate of Incorporation of the Registrant</u>  | 3.1   | Form 8-K<br>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               |
| 3.5               | <u>Amended and Restated Bylaws of Comfort Systems USA, Inc.</u>  | 3.1   | Form 8 K<br>March 25, 2016 |
| 10.1              | <u>Form of Promissory Note, dated April 1, 2017, issued by the Company in favor of each of the Selling Shareholders</u>  | 10.1  | Form 8 K<br>April 3, 2017  |
| 31.1              | <u>Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002</u>  |   | Form 8-K<br>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<br>Herewith      |
| 32.2              | <u>Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002</u>  |   | Furnished<br>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.

July 27, 2017 By: /s/ Brian E. Lane  
Brian E. Lane  
President, Chief Executive Officer and Director

July 27, 2017 By: /s/ William George  
William George  
Executive Vice President and Chief Financial Officer

July 27, 2017 By: /s/ Julie S. Shaeff  
Julie S. Shaeff  
Senior Vice President and Chief Accounting Officer