



Watsco, Inc. (WSO)

Updated October 20th, 2022 by Nathan Parsh

Key Metrics

Current Price:	\$242	5 Year CAGR Estimate:	21.5%	Market Cap:	\$9.4 B
Fair Value Price:	\$361	5 Year Growth Estimate:	10.0%	Ex-Dividend Date:	1/13/2023 ¹
% Fair Value:	67%	5 Year Valuation Multiple Estimate:	8.3%	Dividend Payment Date:	1/30/2023 ²
Dividend Yield:	3.6%	5 Year Price Target	\$581	Years Of Dividend Growth:	9
Dividend Risk Score:	D	Retirement Suitability Score:	D	Rating:	Buy

Overview & Current Events

Watsco sells heating, ventilation and air condition equipment to customers in the U.S., Puerto Rico, Canada and Mexico. The company's products include residential and commercial air condition as well as gas, electric and oil furnaces. Watsco also provides parts such as compressors, evaporator coils, ductworks, thermostats and insulation materials. The company generated revenue of just over \$6 billion in 2021.

On October 20th, 2022, Watsco increased its quarterly dividend 11% to \$2.45 beginning in January of next year, which will extend the company's dividend growth streak to 10 consecutive years.

Also on October 20th, 2022, Watsco reported third quarter earnings results for the period ending September 30th, 2022. Revenue grew 14% to a third quarter record \$2.04 billion, but was \$10 million less than expected. GAAP earnings-per-share of \$4.03 compared favorably to \$3.62 in the prior year, but was \$0.43 below estimates. Earnings-per-share were a quarterly record.

Record top-line growth was led by comparable sales growth of 17% year-to-date. HVAC equipment sales, which represented 69% of total sales, increased 13%. Other HVAC products, which contributed 27% of sales, improved 15% while commercial refrigeration products, which accounted for 4% of sales, was up 18%. The operating margin was flat at 11.6% while operating income grew 14% to a record \$236 million.

We expect Watsco to earn \$14.44 in 2022, compared to \$14.64 and \$12.03, previously. Achieving the new estimate would represent 34% growth year-over-year. We have updated our forecast accordingly.

Growth on a Per-Share Basis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
EPS	\$3.03	\$3.68	\$4.32	\$4.90	\$5.15	\$5.54	\$6.49	\$6.50	\$7.01	\$10.78	\$14.44	\$23.26
DPS	\$2.48	\$1.15	\$2.00	\$2.80	\$3.60	\$4.60	\$5.60	\$6.40	\$6.93	\$7.63	\$8.80	\$14.17
Shares³	35	35	35	35	36	37	37	38	39	35	36	36

Watsco has grown earnings-per-share by at least 15% over both the last five- and 10-year periods of time. The company was able to accomplish this even as it increased its share count over the last decade. We feel an expected earnings-per-share growth rate of 10% is an appropriate starting place given Watsco's earnings history.

The company did cut its dividend by more than half in 2013, but has raised its every year since. However, the dividend increase doesn't often follow a predictable schedule. Sometimes the dividend is raised after four consecutive payments, sometimes after two consecutive payments.

¹ Estimated ex-dividend date

² Estimated dividend payment date

³ Share count in millions

Disclosure: This analyst has no position in the security discussed in this research report, and no plans to initiate one in the next 72 hours.



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Valuation Analysis

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Now	2027
Avg. P/E	23.9	23.8	22.6	24.8	26.3	27.5	26.3	24.7	28.1	29.0	16.8	25.0
Avg. Yld.	3.4%	1.3%	2.1%	2.3%	2.7%	3.0%	3.3%	4.0%	3.5%	2.4%	3.6%	2.4%

Shares of Watsco have declined \$10, or 4.0%, since our July 27th, 2022 report. The stock has traded with a premium multiple for much of the last 10 years, as the average price-earnings ratio is more than 25 over this period of time. We feel that this is an appropriate starting point for our target valuation for the stock given the historical earnings multiple, recent record setting results, and growth expectations going forward. With shares trading at a price-to-earnings ratio of 16.8, this implies a tailwind from multiple expansion. Reverting to our target valuation would add 8.3% to annual returns through 2027.

Safety, Quality, Competitive Advantage, & Recession Resiliency

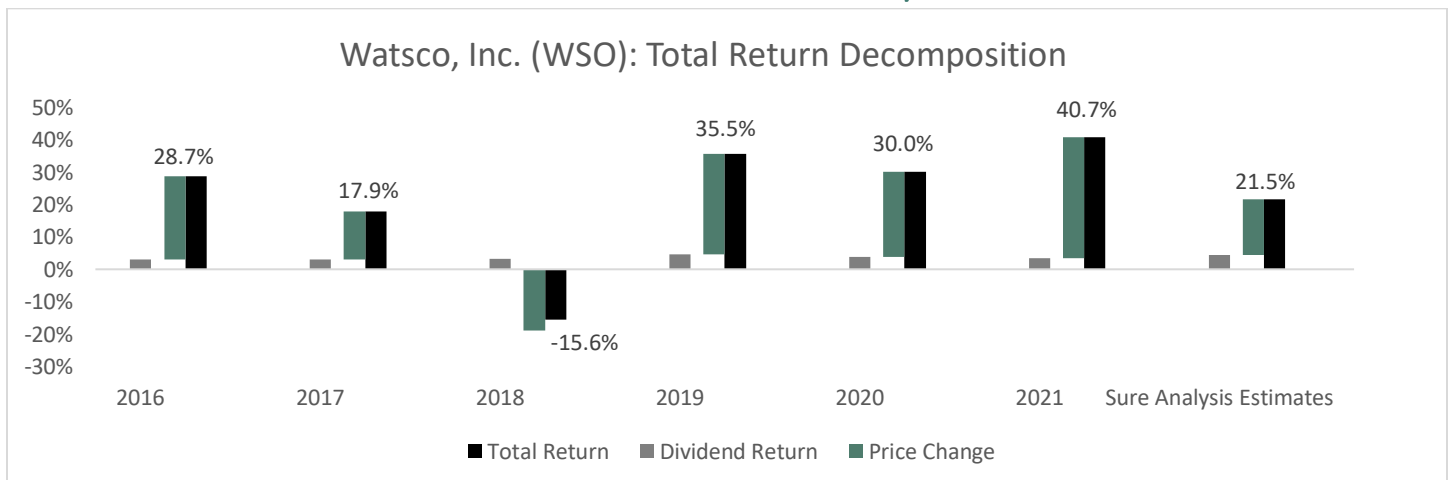
Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2027
Payout	82%	31%	46%	57%	70%	83%	86%	98%	99%	71%	61%	61%

As a medium-sized player in its industry, we don't feel that Watsco has significant competitive advantages, though the company rebounded sharply from the last recession. Like many companies in the industry, Watsco was not immune to the impact of the last recession. The company reported earnings-per-share of \$2.43, \$2.18 and \$1.40 for 2007, 2008 and 2009, respectively. This resulted in a 42% decline over this period of time. However, the company followed this up with earnings-per-share growth the very next year, a trend that has continued every year since. While we believe that the next recession could have an equally painful impact on the company, Watsco is likely to see an improvement in business following the next economic downturn.

Final Thoughts & Recommendation

Watsco is expected to return 21.5% annually through 2027, up from our prior estimate of 20.8%. Our projected return stems from a 10% earnings growth rate, a starting yield of 3.6%, and a high single-digit contribution from multiple expansion. The momentum Watsco experienced at the end of last year and the first two quarters of 2022 have continued into the third quarter as all businesses showed robust growth once again. We have lowered our five-year target price \$8 to \$581 due to earnings estimates, but maintain our buy rating on shares of Watsco due to projected returns.

Total Return Breakdown by Year



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Income Statement Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Revenue	3,432	3,743	3,945	4,113	4,221	4,342	4,547	4,770	5,055	6,280
Gross Profit	814	899	956	1,007	1,035	1,066	1,120	1,157	1,223	1,668
Gross Margin	23.7%	24.0%	24.2%	24.5%	24.5%	24.5%	24.6%	24.3%	24.2%	26.6%
SG&A Exp.	589	628	651	671	689	716	757	800	833	1,058
Depr. & Amort.	16	18	18	19	20	22	22	25	26	
Operating Profit	225	271	306	337	346	350	363	357	390	629
Op. Margin	6.6%	7.2%	7.8%	8.2%	8.2%	8.1%	8.0%	7.5%	7.7%	10.0%
Net Profit	103	128	151	173	183	208	243	246	270	419
Net Margin	3.0%	3.4%	3.8%	4.2%	4.3%	4.8%	5.3%	5.2%	5.3%	6.7%
Free Cash Flow	161	136	123	199	238	289	153	318	518	325
Income Tax	63	78	92	105	106	90	73	67	77	129

Balance Sheet Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total Assets	1,682	1,670	1,791	1,788	1,875	2,047	2,161	2,556	2,484	3,086
Cash & Equivalents	74	19	24	35	56	80	83	74	146	118
Acc. Receivable	378	400	434	451	476	478	502	534	535	698
Inventories	546	583	678	674	685	761	837	921	781	1,115
Goodwill & Int.	617	596	574	539	538	544	540	583	582	745
Total Liabilities	660	542	659	585	623	496	559	841	705	1,088
Accounts Payable	185	141	173	145	185	230	200	240	252	
Long-Term Debt	316	231	304	246	236	22	136	225	72	174
Total Equity	748	840	884	957	1,006	1,298	1,348	1,435	1,487	1,665
LTD/E Ratio	0.42	0.27	0.34	0.26	0.23	0.02	0.10	0.16	0.05	0.10

Profitability & Per Share Metrics

Year	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Return on Assets	7.0%	7.6%	8.7%	9.7%	10.0%	10.6%	11.5%	10.4%	10.7%	15.0%
Return on Equity	13.3%	16.1%	17.6%	18.8%	18.6%	18.1%	18.4%	17.7%	18.5%	26.6%
ROIC	8.8%	9.5%	10.8%	12.0%	12.4%	13.6%	14.7%	13.4%	14.2%	20.8%
Shares Out.	35	35	35	35	36	37	37	38	39	35
Revenue/Share	108.10	116.04	121.90	126.64	129.40	132.12	132.27	137.57	143.81	161.97
FCF/Share	5.07	4.21	3.82	6.13	7.30	8.78	4.46	9.17	14.74	8.39

Note: All figures in millions of U.S. Dollars unless per share or indicated otherwise.

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