

COMFORT SYSTEMS USA INC  
Form 10-Q  
April 27, 2016

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

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

**For the quarterly period ended March 31, 2016**

**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**  
(State or other jurisdiction of  
Incorporation or Organization)

**76-0526487**  
(I.R.S. Employer  
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

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12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act).

Large accelerated filer	Accelerated filer	Non-accelerated filer	Smaller reporting
<input checked="" type="checkbox"/>	<input type="checkbox"/>	<input type="checkbox"/>	company
		(Do not check if a smaller reporting company)	<input type="checkbox"/>

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

The number of shares outstanding of the issuer's common stock as of April 20, 2016 was 37,444,146 (excluding treasury shares of 3,679,219).

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FOR THE QUARTER ENDED MARCH 31, 2016**

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## COMFORT SYSTEMS USA, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts)

	March 31, 2016	December 31, 2015
	(Unaudited)	
<b>ASSETS</b>		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 43,540	\$ 56,464
Accounts receivable, less allowance for doubtful accounts of \$4,998 and \$5,158, respectively	306,111	302,052
Other receivables	15,181	20,642
Inventories	9,783	7,941
Prepaid expenses and other	5,719	5,836
Costs and estimated earnings in excess of billings	34,350	31,338
Total current assets	414,684	424,273
PROPERTY AND EQUIPMENT, NET	62,557	60,813
GOODWILL	147,297	143,874
IDENTIFIABLE INTANGIBLE ASSETS, NET	49,140	41,079
DEFERRED INCOME TAX ASSETS	29,240	16,276
OTHER NONCURRENT ASSETS	6,051	5,279
Total assets	\$ 708,969	\$ 691,594
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 600	\$ 500
Current maturities of long-term capital lease obligations	241	251
Accounts payable	106,536	106,684
Accrued compensation and benefits	50,506	54,079
Billings in excess of costs and estimated earnings	83,810	85,397
Accrued self-insurance	29,863	29,803
Other current liabilities	35,320	28,677
Total current liabilities	306,876	305,391
LONG-TERM DEBT	53,530	10,500
LONG-TERM CAPITAL LEASE OBLIGATIONS	200	256
DEFERRED INCOME TAX LIABILITIES	1,810	1,810
OTHER LONG-TERM LIABILITIES	8,479	8,632
Total liabilities	370,895	326,589
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding		
Common stock, \$.01 par, 102,969,912 shares authorized, 41,123,365 and 41,123,365 shares issued, respectively	411	411
Treasury stock, at cost, 3,730,986 and 3,696,781 shares, respectively	(49,118)	(46,845)
Additional paid-in capital	310,062	323,765
Retained earnings	76,719	69,390
Comfort Systems USA, Inc. stockholders' equity	338,074	346,721

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Noncontrolling interests		18,284
Total stockholders' equity	338,074	365,005
Total liabilities and stockholders' equity	\$ 708,969	\$ 691,594

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 March 31,	
	2016	2015
REVENUE	\$ 385,942	\$ 369,547
COST OF SERVICES	312,440	304,859
Gross profit	73,502	64,688
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	58,181	53,696
GAIN ON SALE OF ASSETS	(145)	(176)
Operating income	15,466	11,168
OTHER INCOME (EXPENSE):		
Interest income	1	1
Interest expense	(701)	(505)
Other	486	18
Other income (expense)	(214)	(486)
INCOME BEFORE INCOME TAXES	15,252	10,682
INCOME TAX EXPENSE	5,497	3,793
NET INCOME INCLUDING NONCONTROLLING INTERESTS	9,755	6,889
Less: Net income attributable to noncontrolling interests		1,823
NET INCOME ATTRIBUTABLE TO COMFORT SYSTEMS USA, INC.	\$ 9,755	\$ 5,066
INCOME PER SHARE ATTRIBUTABLE TO COMFORT SYSTEMS USA, INC.:		
Basic		
Net income	\$ 0.26	\$ 0.14
Diluted		
Net income	\$ 0.26	\$ 0.13
SHARES USED IN COMPUTING INCOME PER SHARE:		
Basic		
	37,344	37,281
Diluted		
	37,730	37,605

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DIVIDENDS PER SHARE	\$	0.065	\$	0.060
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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		Treasury Stock		Additional Paid-In Capital	Retained Earnings	Non-Controlling Interests	Total Stockholders' Equity
	Shares	Amount	Shares	Amount				
BALANCE AT DECEMBER 31, 2014	41,123,365	\$ 411	(3,853,586)	\$ (43,598)	\$ 320,084	\$ 29,384	\$ 15,112	\$ 321,393
Net income						49,364	8,076	57,440
Issuance of stock:								
Issuance of shares for options exercised including tax benefit			317,333	3,728	966			4,694
Issuance of restricted stock & performance stock			200,015	2,292	(626)			1,666
Shares received in lieu of tax withholding payment on vested restricted stock			(44,590)	(937)				(937)
Tax benefit from vesting of restricted stock					284			284
Stock-based compensation					3,057			3,057
Dividends						(9,358)		(9,358)
Distribution to noncontrolling interests							(4,904)	(4,904)
Share repurchase			(315,953)	(8,330)				(8,330)
BALANCE AT DECEMBER 31, 2015	41,123,365	411	(3,696,781)	(46,845)	323,765	69,390	18,284	365,005
Net income (unaudited)						9,755		9,755
Issuance of stock:								
Issuance of shares for options exercised including tax benefit (unaudited)			21,244	278	92			370
Issuance of restricted stock & performance stock (unaudited)			65,086	851	1,125			1,976
Shares received in lieu of tax withholding payment on vested restricted stock (unaudited)			(18,506)	(562)				(562)
Stock-based compensation (unaudited)					990			990
Dividends (unaudited)						(2,426)		(2,426)
Acquisition of noncontrolling interests (unaudited)					(15,910)		(18,284)	(34,194)
Share repurchase (unaudited)			(102,029)	(2,840)				(2,840)
BALANCE AT MARCH 31, 2016 (unaudited)	41,123,365	\$ 411	(3,730,986)	\$ (49,118)	\$ 310,062	\$ 76,719		\$ 338,074

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)

	Three Months Ended March 31,	
	2016	2015
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income including noncontrolling interests	\$ 9,755	\$ 6,889
Adjustments to reconcile net income to net cash provided by (used in) operating activities		
Amortization of identifiable intangible assets	2,039	1,831
Depreciation expense	4,219	3,792
Bad debt expense	(262)	211
Deferred tax benefit	(1,022)	(1,241)
Amortization of debt financing costs	85	93
Gain on sale of assets	(145)	(176)
Stock-based compensation expense	1,476	1,388
Changes in operating assets and liabilities, net of effects of acquisitions		
(Increase) decrease in		
Receivables, net	17,142	2,854
Inventories	(370)	(1,263)
Prepaid expenses and other current assets	(179)	735
Costs and estimated earnings in excess of billings	(1,837)	(3,592)
Other noncurrent assets	49	278
Increase (decrease) in		
Accounts payable and accrued liabilities	(9,316)	3,721
Billings in excess of costs and estimated earnings	(8,526)	4,817
Other long-term liabilities	(86)	78
Net cash provided by operating activities	13,022	20,415
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment	(3,765)	(3,623)
Proceeds from sales of property and equipment	220	206
Cash paid for acquisitions, net of cash acquired	(57,071)	(5,350)
Net cash used in investing activities	(60,616)	(8,767)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from revolving line of credit	132,000	14,500
Payments on revolving line of credit	(91,000)	(17,000)
Payments on other debt	(17)	
Payments on capital lease obligations	(66)	(84)
Debt financing costs	(789)	
Payments of dividends to shareholders	(2,426)	(2,237)
Share repurchase program	(2,840)	
Shares received in lieu of tax withholding	(562)	
Excess tax benefit of stock-based compensation	95	90
Proceeds from exercise of options	275	297
Distributions to noncontrolling interests		(41)
Payments for contingent consideration arrangements		(345)
Net cash provided by (used in) financing activities	34,670	(4,820)

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NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(12,924)	6,828
CASH AND CASH EQUIVALENTS, beginning of period	56,464	32,064
CASH AND CASH EQUIVALENTS, end of period	\$ 43,540	\$ 38,892

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

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## COMFORT SYSTEMS USA, INC.

## CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

March 31, 2016

(Unaudited)

**1. Business and Organization**

Comfort Systems USA, Inc., a Delaware corporation, provides comprehensive mechanical contracting services, which principally includes heating, ventilation and air conditioning ("HVAC"), plumbing, piping and controls, as well as off-site construction, electrical, monitoring and fire protection. We install, maintain, repair and replace products and systems throughout the United States. Approximately 41% of our consolidated 2016 revenue is attributable to installation of systems in newly constructed facilities, with the remaining 59% attributable to maintenance, repair and replacement services.

Our consolidated 2016 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	\$ 289,456	75%
Plumbing	54,032	14%
Building Automation Control Systems	23,157	6%
Other	19,297	5%
Total	\$ 385,942	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, 2015 (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. Certain amounts in prior periods may have been reclassified to conform to the current year presentation. The effects of the reclassifications were not material to the unaudited consolidated financial statements. 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.

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**COMFORT SYSTEMS USA, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2016**

**(Unaudited)**

**2. Summary of Significant Accounting Policies (Continued)**

Actual results could differ from those estimates. The most significant estimates used in our financial statements affect revenue and cost recognition for construction contracts, the allowance for doubtful accounts, self-insurance accruals, deferred tax assets, warranty accruals, fair value accounting for acquisitions and the quantification of fair value for reporting units in connection with our goodwill impairment testing.

***Recent Accounting Pronouncements***

In May 2014, the Financial Accounting Standards Board ("FASB") issued 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 at the date of initial application. We currently plan to use the modified retrospective basis on the adoption date. It is effective for annual periods beginning after December 15, 2017, including interim periods within that reporting period. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory", which requires that inventory within the scope of the guidance be measured at the lower of cost and net realizable value. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonable predictable costs of completion, disposal and transportation. Inventory measured using last-in, first-out (LIFO) and the retail inventory method (RIM) are not impacted by the new guidance. Entities should apply the new guidance prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. It is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"). 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 March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, "Compensation - Stock Compensation (Topic 718)" ("ASU 2016-09"). The standard will change certain aspects of accounting for share-based payments to employees. Specifically, the new guidance requires all income tax effects to be recognized in the income statement when the awards vest or are settled. It will also allow an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election to account for forfeitures as they occur. ASU 2016-09 is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016. Early adoption

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## COMFORT SYSTEMS USA, INC.

## CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

**2. Summary of Significant Accounting Policies (Continued)**

is permitted, but all of the guidance must be adopted in the same period. We are currently evaluating the potential impact of this authoritative guidance 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.

**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 March 31, 2016 (in thousands):

	Balance March 31, 2016	Fair Value Measurements at Reporting Date Using Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash and cash equivalents	\$ 43,540	\$ 43,540	\$	\$
Life insurance cash surrender value	\$ 3,618	\$	\$ 3,618	\$
Contingent earn-out obligations	\$ 3,690	\$	\$	\$ 3,690

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.

Table of Contents**COMFORT SYSTEMS USA, INC.****CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2016****(Unaudited)****3. Fair Value Measurements (Continued)**

One of our operations has life insurance policies covering 49 employees with a combined face value of \$45.7 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 is \$3.6 million as of March 31, 2016 and \$3.6 million as of December 31, 2015. 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	\$ 450
Issuances	3,240
Settlements	
Adjustments to fair value	
Balance at end of period	\$ 3,690

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

**4. Acquisitions**

We completed 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 \$47.0 million, including \$42.0 million funded on the closing date plus a holdback, an earn-out that we will pay 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 preliminary 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. Shoffner was included in our consolidated results of operations beginning on its acquisition date, which included revenue of \$14.5 million. The preliminary acquisition date fair value of

Table of Contents**COMFORT SYSTEMS USA, INC.****CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****March 31, 2016****(Unaudited)****4. Acquisitions (Continued)**

consideration transferred for this acquisition was \$19.5 million, of which \$13.5 million was allocated to goodwill and identifiable intangible assets. The preliminary purchase price included \$15.5 million funded on the closing date plus a note payable to former owners, an earn-out that we will pay if certain financial targets are met after the acquisition date and a working capital adjustment. Our consolidated balance sheet includes preliminary allocations of the purchase price to the assets acquired and liabilities assumed for this acquisition pending the completion of the final valuation of intangible assets and accrued liabilities. The acquisitions completed in the current year were not material, individually or in the aggregate.

***Other Acquisitions***

We funded cash of \$0.8 million in the first quarter of 2016 for an acquisition completed in the fourth quarter of 2015. We also completed two acquisitions in the first quarter of 2015. These acquisitions were not material and were "tucked-in" with existing operations. The total purchase price for the "tucked-in" acquisitions, including earn-outs, was \$6.7 million in the first quarter of 2015.

The results of operations of acquisitions are included in our consolidated financial statements from their respective acquisition dates. 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):

	<b>March 31, 2016</b>	<b>December 31, 2015</b>
Balance at beginning of year	\$ 143,874	\$ 140,341
Additions	3,423	3,533
Balance at end of period	\$ 147,297	\$ 143,874

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## COMFORT SYSTEMS USA, INC.

## CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

**6. Debt Obligations**

Debt obligations consist of the following (in thousands):

	March 31, 2016	December 31, 2015
Revolving credit facility	\$ 51,000	\$ 10,000
Notes to former owners	2,750	1,000
Other debt	380	
Capital lease obligations	441	507
<b>Total debt</b>	<b>54,571</b>	<b>11,507</b>
Less current portion	(841)	(751)
<b>Total long-term portion of debt</b>	<b>\$ 53,730</b>	<b>\$ 10,756</b>

***Revolving Credit Facility***

On February 22, 2016, we amended our senior credit facility (the "Facility") provided by a syndicate of banks, increasing our borrowing capacity from \$250.0 million to \$325.0 million, 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 March 31, 2016, we had \$51.0 million of outstanding borrowings, \$41.5 million in letters of credit outstanding and \$232.5 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 Credit Facility Adjusted EBITDA			
	Less than 0.75	0.75 to 1.50	1.50 to 2.25	2.25 or greater
<b>Additional Per Annum Interest Margin Added Under:</b>				
Base Rate Loan Option	0.25%	0.50%	0.75%	1.00%
Eurodollar Rate Loan Option	1.25%	1.50%	1.75%	2.00%

The weighted average interest rate applicable to the borrowings under the Facility was approximately 1.7% as of March 31, 2016.

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





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COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

**6. Debt Obligations (Continued)**

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.

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 March 31, 2016 was 0.4.

*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 March 31, 2016 was 30.4.

*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.

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**COMFORT SYSTEMS USA, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2016**

**(Unaudited)**

**6. Debt Obligations (Continued)**

We were in compliance with all of our financial covenants as of March 31, 2016.

*Notes to Former Owners*

As part of the consideration used to acquire two companies, we have outstanding subordinated notes to the former owners. These notes had an outstanding balance of \$2.8 million as of March 31, 2016. In conjunction with the Shoffner acquisition in the first quarter, we issued a subordinated note to former owners with an outstanding balance of \$1.8 million as of March 31, 2016 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 subordinated note to the former owners with an outstanding balance of \$1.0 million as of March 31, 2016 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in equal installments in October 2016 and 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 March 31, 2016, \$0.4 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 March 31, 2016, \$0.4 million of capital lease obligations were outstanding, of which \$0.2 million was considered current.

**7. Commitments and Contingencies**

*Claims and Lawsuits*

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

*Surety*

Many customers, particularly in connection with new construction, require us to post performance and payment bonds issued by a financial institution known as a surety. If we fail to perform under the terms of a contract or to pay subcontractors and vendors who provided goods or services under a contract, the customer may demand that the surety make payments or provide services under the bond.

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**COMFORT SYSTEMS USA, INC.**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**March 31, 2016**

**(Unaudited)**

**7. Commitments and Contingencies (Continued)**

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 up to deductible amounts are estimated and accrued based upon known facts, historical trends and industry averages. 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, contingently issuable 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.

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.

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## COMFORT SYSTEMS USA, INC.

## CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

March 31, 2016

(Unaudited)

**8. Stockholders' Equity (Continued)**

There were approximately 0.1 million anti-dilutive stock options excluded from the calculation of diluted EPS for the three months ended March 31, 2016 and for the three months ended March 31, 2015.

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 Ended March 31,	
	2016	2015
Common shares outstanding, end of period	37,392	37,307
Effect of using weighted average common shares outstanding	(48)	(26)
Shares used in computing earnings per share basic	37,344	37,281
Effect of shares issuable under stock option plans based on the treasury stock method	241	233
Effect of contingently issuable restricted shares	145	91
Shares used in computing earnings per share diluted	37,730	37,605

***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 7.6 million shares to be repurchased. As of March 31, 2016, we have repurchased a cumulative total of 7.0 million shares at an average price of \$12.22 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 current quarter, we repurchased 0.1 million shares for approximately \$2.8 million at an average price of \$27.84 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, 2015 (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 82% 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 more broadly to support our operations but which are not specific to the project. Typically customers will seek bids from competitors for a given project. While the criteria on which customers select the winning bid 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 is the most influential factor for most customers in choosing a mechanical installation and service provider.

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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, typically for six months. Amounts withheld under this practice are known as retention or retainage.

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, although such projects are sometimes subject to a guaranteed maximum cost. These margins are frequently less than fixed-price contract margins because there is less risk of unrecoverable cost overruns in cost-plus or time and materials work.

As of March 31, 2016 we had 4,079 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$502,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration together with typical retention terms as discussed above generally allow us to complete the realization of revenue and earnings in cash within one year. We have what we believe is a well-diversified distribution of revenue across end-use sectors that we believe reduces our exposure to negative developments in any given sector. Because of the integral nature of HVAC and related controls systems to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

A stratification of projects in progress as of March 31, 2016, by contract price, is as follows:

<b>Contract Price of Project</b>	<b>No. of Projects</b>	<b>Aggregate Contract Price Value (millions)</b>
Under \$1 million	3,676	\$ 416.4
\$1 million - \$5 million	309	685.2
\$5 million - \$10 million	59	400.4
\$10 million - \$15 million	21	254.0
Greater than \$15 million	14	291.5
Total	4,079	\$ 2,047.5

In addition to project work, approximately 18% 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 usually 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

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agreements typically cover periods ranging from one to three years with 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. We will also typically use proprietary information systems to maintain information on the customer's sites and equipment, including performance and service records, and related cost data. These systems track the status of ongoing service and installation work, and may also monitor system performance data. Under these contractual relationships, we usually provide consolidated billing and credit payment terms to the customer.

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

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



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***Operating Environment and Management Emphasis***

Nonresidential building construction and renovation activity, as reported by the federal government, declined over the four year period from 2009 to 2012, with 2013 and 2014 activity levels relatively stable at the low levels of the preceding years followed by an increase in activity in 2015. While we expect that activity levels and the underlying environment for nonresidential construction activity will remain below prior peaks, we have seen industry conditions in the first quarter of 2016 continue at the improved levels we saw in 2015.

As a result of our continued strong emphasis on cash flow, at March 31, 2016 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 seventeen 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 changing conditions. We will continue our efforts to expand and improve our service business, to find the more active sectors in our markets, and to increase our regional and national account business. Our primary emphasis for 2016 will be on execution and cost control, but we are seeking growth based on our belief that industry conditions are beginning to improve, 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 service growth and improved performance.

***Cyclicality and Seasonality***

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

The HVAC industry is subject to seasonal variations. Specifically, 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.

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	Three Months Ended March 31,			
	2016	%	2015	%
Revenue	\$ 385,942	100.0%	\$ 369,547	100.0%
Cost of services	312,440	81.0%	304,859	82.5%
Gross profit	73,502	19.0%	64,688	17.5%
Selling, general and administrative expenses	58,181	15.1%	53,696	14.5%
Gain on sale of assets	(145)		(176)	
Operating income	15,466	4.0%	11,168	3.0%
Interest income	1		1	
Interest expense	(701)	(0.2)%	(505)	(0.1)%
Other income (expense)	486	0.1%	18	
Income before income taxes	15,252	4.0%	10,682	2.9%
Income tax expense	5,497		3,793	
Net income including noncontrolling interests	9,755	2.5%	6,889	1.9%
Less: Net income attributable to noncontrolling interests			1,823	
Net income attributable to Comfort Systems USA, Inc.	\$ 9,755		\$ 5,066	

We had 35 operating locations as of December 31, 2015. We completed one acquisition in the first quarter of 2016, known as "Shoffner", that reports as a separate operating location in the Knoxville, Tennessee area. In addition, we merged four operating locations into two operating locations during the current quarter, and created two operating locations out of one existing operating location. As of March 31, 2016, we had 35 operating locations. Acquisitions are included in our results of operations from the respective acquisition date. The same-store comparison from 2016 to 2015, as described below, excludes two months of results 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 \$16.4 million, or 4.4%, to \$385.9 million for the first quarter of 2016 compared to the same period in 2015. The increase included a 0.5% increase in revenue related to same-store activity and a 3.9% increase related to the acquisition of Shoffner. The same-store revenue slight increase is primarily due to our Michigan operation (\$8.0 million), one of our Virginia operations (\$6.1 million) and our combined New York operations (\$6.7 million) which was partially offset by lower revenue at our EAS operation (\$19.5 million), which experienced decreased large project work compared to the prior year, specifically in the manufacturing sector.

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

Backlog as of March 31, 2016 was \$776.9 million, a 9.2% increase from December 31, 2015 backlog of \$711.6 million, and an 8.2% increase from March 31, 2015 backlog of \$718.0 million.

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Sequential backlog increased mainly due to the aforementioned acquisition of Shoffner (\$56.4 million or 7.9%). Same-store backlog remained relatively flat as increases at our Northern Texas operation (\$15.6 million) and our EAS operation (\$15.1 million) were offset by decreases due to completion of project work, primarily at one of our Virginia operations (\$8.3 million) and one of our Maryland operations (\$7.5 million). The year-over-year backlog increase was also primarily due to the Shoffner acquisition (7.8%). Same-store backlog remained flat as increases at our Michigan operation (\$16.0 million), our Northern Texas operation (\$15.1 million) and our EAS operation (\$14.0 million) were offset by decreases due to completion of project work, primarily at our California operation (\$21.2 million) and one of our Maryland operations (\$14.3 million).

**Gross Profit** Gross profit increased \$8.8 million, or 13.6%, to \$73.5 million for the first quarter of 2016 as compared to the same period in 2015. The increase included a \$2.0 million, or 3.0%, increase related to the acquisition of Shoffner and a \$6.8 million, or 10.6%, increase on a same-store basis. The same-store increase in gross profit was primarily due to the impact of increased volumes at our Michigan operation (\$1.7 million) and improved project execution at our Northern Texas operation (\$1.7 million), one of our Tennessee operations (\$1.1 million) and our combined New York operations (\$1.5 million). This was partially offset by a decrease at our EAS operation (\$1.6 million) which has experienced a decrease in volumes in the current quarter when compared to the same period in 2015. As a percentage of revenue, gross profit increased from 17.5% in 2015 to 19.0% in 2016 primarily due to the factors discussed above.

**Selling, General and Administrative Expenses ("SG&A")** SG&A increased \$4.5 million, or 8.4%, to \$58.2 million for the first quarter of 2016 as compared to 2015. On a same-store basis, excluding amortization expense, SG&A increased \$2.9 million, or 5.6%. This increase is primarily due to increased compensation costs (approximately \$1.7 million) which are primarily related to expanded service activities at multiple locations. Amortization expense remained relatively flat during the period. As a percentage of revenue, SG&A increased from 14.5% in 2015 to 15.1% in 2016 primarily due to the expanded service activities.

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
	<b>(in thousands)</b>	
SG&A	\$ 58,181	\$ 53,696
Less: SG&A from companies acquired	(1,683)	
Less: Amortization expense	(1,563)	(1,685)
Same-store SG&A, excluding amortization expense	\$ 54,935	\$ 52,011

**Interest Expense** Interest expense increased \$0.2 million, or 38.8%, to \$0.7 million for the first quarter of 2016 as compared to the same period in 2015. The increase is due to higher net borrowings on the revolving credit facility, primarily used to fund acquisitions.

**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

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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 three months ended March 31, 2016 our tax expense was \$5.5 million with an effective tax rate of 36.0% as compared to tax expense of \$3.8 million with an effective tax rate of 35.5% for the three months ended March 31, 2015. The effective rate for 2016 is higher than the federal statutory rate of 35.0% primarily due to state income taxes (4.0%) and non-deductible expenses (0.8%) partially offset by the production activity deduction (2.1%) and a decrease in valuation allowance (1.8%). The effective rate for 2015 was higher than the federal statutory rate of 35.0% primarily due to state income taxes (3.9%) and non-deductible expenses (1.3%) partially offset by the impact of the noncontrolling interest of EAS which for tax purposes was treated as a partnership (2.7%) and the production activity deduction (1.8%). 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 2016 will be between 35% and 40%.

*Net Income Attributable to Noncontrolling Interests* There was no net income attributable to noncontrolling interests for the first quarter of 2016 due to our January 1, 2016 purchase of the remaining 40% noncontrolling interest in Environmental Air Systems, LLC.

### **Outlook**

We have seen industry conditions improve during 2015 and the first quarter of 2016 compared to the previous years. Our emphasis for 2016 will be 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 backlog, and in light of economic conditions for our industry, we expect that revenue and profitability in 2016 will be similar to or above the levels that we experienced in 2015.

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

	<b>Three Months Ended</b>	
	<b>March 31,</b>	
	<b>2016</b>	<b>2015</b>
Cash provided by (used in):		
Operating activities	\$ 13,022	\$ 20,415
Investing activities	(60,616)	(8,767)
Financing activities	34,670	(4,820)
 Net increase (decrease) in cash and cash equivalents	 \$ (12,924)	 \$ 6,828

#### Free cash flow:

Cash provided by operating activities	\$ 13,022	\$ 20,415
Purchases of property and equipment	(3,765)	(3,623)
Proceeds from sales of property and equipment	220	206
 Free cash flow	 \$ 9,477	 \$ 16,998

### **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

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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 \$13.0 million during the first quarter of 2016 compared with \$20.4 million during the first quarter in 2015. The \$7.4 million decrease is primarily due to decreases in billings in excess of costs and estimated earnings and accounts payable and accrued liabilities which had an impact of \$13.3 million and \$13.0 million, respectively. These decreases are primarily due to the timing of billings and various project work. These uses of operating cash flow were partially offset by a corresponding decrease in receivables of \$14.3 million primarily related to these projects and overall higher net income in the first quarter of 2016 compared to the first quarter of 2015.

*Cash Used in Investing Activities* During the first quarter of 2016, cash used in investing activities was \$60.6 million compared to \$8.8 million during the first quarter of 2015. The \$51.8 million increase in cash used primarily relates to cash paid for the EAS and Shoffner acquisitions in 2016 (\$56.3 million).

*Cash Provided by (Used in) Financing Activities* Cash provided by financing activities was \$34.7 million for the first quarter of 2016 compared to cash used in financing activities of \$4.8 million during the first quarter of 2015. The \$39.5 million increase in cash provided by financing activities is primarily due to net borrowings on the revolving credit facility during the current quarter of \$41.0 million compared to net payments during the first quarter of 2015 of \$2.5 million. This impact was partially offset by share repurchases of \$2.8 million in the current quarter compared to no share repurchase activity during the first quarter of 2015.

*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.

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***Share Repurchase Program***

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time approved extensions of the program to acquire additional shares. Since the inception of the repurchase program, the Board has approved 7.6 million shares to be repurchased. As of March 31, 2016, we have repurchased a cumulative total of 7.0 million shares at an average price of \$12.22 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 current quarter, we repurchased 0.1 million shares for approximately \$2.8 million at an average price of \$27.84 per share.

***Debt***

***Revolving Credit Facility***

On February 22, 2016, we amended our senior credit facility (the "Facility") provided by a syndicate of banks, increasing our borrowing capacity from \$250.0 million to \$325.0 million, 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 March 31, 2016, we had \$51.0 million of outstanding borrowings, \$41.5 million in letters of credit outstanding and \$232.5 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.

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 March 31, 2016 was 0.4.

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*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 March 31, 2016 was 30.4.

*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 March 31, 2016.

***Notes to Former Owners***

As part of the consideration used to acquire two companies, we have outstanding subordinated notes to the former owners. These notes had an outstanding balance of \$2.8 million as of March 31, 2016. In conjunction with the Shoffner acquisition in the first quarter, we issued a subordinated note to former owners with an outstanding balance of \$1.8 million as of March 31, 2016 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 subordinated note to the former owners with an outstanding balance of \$1.0 million as of March 31, 2016 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in equal installments in October 2016 and 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 March 31, 2016, \$0.4 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 March 31, 2016, \$0.4 million of capital lease obligations were outstanding, of which \$0.2 million was considered current.

***Outlook***

We have generated positive net free cash flow for the last seventeen calendar years, much of which occurred during challenging economic and industry conditions. We also continue to have significant

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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 interruption in the availability of bonding capacity, such an interruption would likely cause our revenue and profits to decline in the near term.



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**Contractual Obligations**

As of March 31, 2016, we have \$41.5 million in letter of credit commitments, of which \$17.3 million will expire in 2016 and \$24.2 million will expire in 2017. 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 2016, 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 1.7% as of March 31, 2016.

We measure certain assets at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. We did not recognize any impairments 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 March 31, 2016 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, 2015, 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 7.6 million shares to be repurchased. As of March 31, 2016, we have repurchased a cumulative total of 7.0 million shares at an average price of \$12.22 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 current quarter, we repurchased 0.1 million shares for approximately \$2.8 million at an average price of \$27.84 per share.

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During the quarter ended March 31, 2016, we purchased our common shares in the following amounts at the following average prices:

<b>Period</b>	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>	<b>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</b>	<b>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs</b>
January 1 - January 31	102,029	\$ 27.84	6,984,350	576,833
February 1 - February 29		\$	6,984,350	576,833
March 1 - March 31		\$	6,984,350	576,833
	102,029	\$ 27.84	6,984,350	576,833

Under our 2012 Equity Plan, employees may elect to have us withhold common shares to satisfy minimum statutory federal, state and local tax withholding obligations arising on the vesting of restricted stock awards and exercise of options. When we withhold these shares, we are required to remit to the appropriate taxing authorities the market price of the shares withheld, which could be deemed a purchase of the common shares by us on the date of withholding.

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#### **Item 6. Exhibits**

<b>Exhibit Number</b>	<b>Description of Exhibits</b>	<b>Exhibit Number</b>	<b>Incorporated by Reference to the Exhibit Indicated Below and to the Filing with the Commission Indicated Below Filing or File Number</b>
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant	3.1	333-24021
3.2	Certificate of Amendment dated May 21, 1998	3.2	1998 Form 10-K
3.3	Certificate of Amendment dated July 9, 2003	3.3	2003 Form 10-K
3.4	Amended and Restated Bylaws of Comfort Systems USA, Inc.	3.1	March 25, 2016 Form 8-K
*10.1	Form of 2016 Restricted Stock Unit Agreement	10.1	March 25, 2016 Form 8-K
*10.2	Form of 2016 Dollar-denominated Performance Restricted Stock Unit Agreement	10.2	March 25, 2016 Form 8-K
*10.3	Form of 2016 Stock Option Notice	10.3	March 25, 2016 Form 8-K
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		Filed Herewith
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		Filed Herewith
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		Furnished Herewith
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		Furnished Herewith
101.INS	XBRL Instance Document		
101.SCH	XBRL Taxonomy Extension Schema Document		
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document		
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document		
101.LAB	XBRL Taxonomy Extension Label Linkbase Document		
101.PRE	XBRL Taxonomy Extension Presentation Linkbase		

\*  
Management contract or compensatory plan.

