JACK IN THE BOX INC /NEW/
Form 10-Q
February 18, 2009

Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended January 18, 2009
Commission File Number: 1-9390
JACK IN THE BOX INC.

(Exact name of registrant as specified in its charter)

DELAWARE	95-2698708
(State of Incorporation)	(I.R.S. Employer Identification No.)
9330 BALBOA AVENUE, SAN DIEGO, CA	92123
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code (858) 571-2121

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 þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Number of shares of common stock, $.01 par value, outstanding as of the close of business February 13, 2009-56,872,511.

JACK IN THE BOX INC. AND SUBSIDIARIES
INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JACK IN THE BOX INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)
(Unaudited)

	January 18, 2009	September 28, 2008
ASSETS		
Current assets:		
Cash and cash equivalents	$ 21,785	$ 47,884
Accounts and other receivables, net	49,747	70,290
Inventories	42,966	45,206
Prepaid expenses	23,394	20,061
Deferred income taxes	46,166	46,166
Assets held for sale	125,753	112,994
Other current assets	5,688	7,480
Total current assets	315,499	350,081
Property and equipment, at cost	1,609,395	1,605,497
Less accumulated depreciation and amortization	(662,386)	(662,435)
Property and equipment, net	947,009	943,062
Other assets, net	198,291	205,275
	$ 1,460,799	$ 1,498,418
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current maturities of long-term debt	$ 12,895	$ 2,331
Accounts payable	82,507	99,708
Accrued liabilities	202,899	213,631
Total current liabilities	298,301	315,670
Long-term debt, net of current maturities	473,547	516,250
Other long-term liabilities	156,948	161,277
Deferred income taxes	46,540	48,110

Stockholders equity:		
Preferred stock $.01 par value, 15,000,000 authorized, none issued		
Common stock $.01 par value, 175,000,000 authorized, 73,567,550 and 73,506,049 issued, respectively	736	735
Capital in excess of par value	157,568	155,023
Retained earnings	824,054	795,657
Accumulated other comprehensive loss, net	(22,436)	(19,845)
Treasury stock, at cost, 16,726,032 shares	(474,459)	(474,459)
Total stockholders equity	485,463	457,111
	$ 1,460,799	$ 1,498,418

See accompanying notes to condensed consolidated financial statements.

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF EARNINGS
(In thousands, except per share data)
(Unaudited)

	Sixteen Weeks Ended	
	January 18, 2009	January 20, 2008
Revenues:		
Restaurant sales	$ 628,649	$ 647,715
Distribution sales	91,523	80,391
Franchised restaurant revenues	56,501	48,891
	776,673	776,997
Operating costs and expenses:		
Restaurant costs of sales	213,888	212,763
Restaurant operating costs	323,283	324,512
Distribution costs of sales	90,579	79,910
Franchised restaurant costs	22,129	18,948
Selling, general and administrative expenses	90,779	90,090
Gains on the sale of company-operated restaurants	(18,361)	(16,349)
	722,297	709,874
Earnings from operations	54,376	67,123
Interest expense	8,201	9,077
Interest income	(474)	(251)
Interest expense, net	7,727	8,826
Earnings from continuing operations and before income taxes	46,649	58,297
Income taxes	18,682	21,998
Earnings from continuing operations	27,967	36,299
Earnings (losses) from discontinued operations, net	430	(44)
Net earnings	$ 28,397	$ 36,255

Net earnings per share basic:				
Earnings from continuing operations	$	0.49	$	0.61
Earnings (losses) from discontinued operations		0.01		
Net earnings per share	$	0.50	$	0.61
Net earnings per share diluted:				
Earnings from continuing operations	$	0.49	$	0.60
Earnings (losses) from discontinued operations		0.00		(0.01)
Net earnings per share	$	0.49	$	0.59
Weighted-average shares outstanding:				
Basic		56,592		59,523
Diluted		57,427		60,938

See accompanying notes to condensed consolidated financial statements.

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

	Sixteen Weeks Ended	
	January 18, 2009	**January 20, 2008**
Cash flows from operating activities:		
Net earnings	$ 28,397	$ 36,255
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	31,681	30,602
Deferred finance cost amortization	478	478
Deferred income taxes	36	(2,979)
Share-based compensation expense awards	2,490	3,120
Pension and postretirement expense	3,768	4,456
Losses on cash surrender value of company-owned life insurance	12,039	5,765
Gains on the sale of company-operated restaurants	(18,361)	(16,349)
Gains on the acquisition of franchise-operated restaurants	(958)	
Losses on the disposition of property and equipment, net	4,355	5,198
Impairment charges	1,689	1,439
Changes in assets and liabilities, excluding acquisitions and dispositions:		
Decrease (increase) in receivables	2,765	(311)
Decrease (increase) in inventories	3,538	(1,871)
Decrease (increase) in prepaid expenses and other current assets	(2,580)	8,863
Decrease in accounts payable	(14,387)	(13,030)
Pension and postretirement contributions	(719)	(3,954)
Decrease in other liabilities	(19,427)	(14,417)
Cash flows provided by operating activities	34,804	43,265
Cash flows from investing activities:		
Purchases of property and equipment	(52,796)	(58,011)
Proceeds from the sale of company-operated restaurants	18,620	21,935
Proceeds from (purchase of) assets held for sale and leaseback, net	(14,543)	3,365
Collections on notes receivable	19,602	12
Acquisition of franchise-operated restaurants	(6,760)	
Other	1,254	(523)
Cash flows used in investing activities	(34,623)	(33,222)
Cash flows from financing activities:		
Borrowings on revolving credit facility	42,000	75,000
Repayments of borrowings on revolving credit facility	(73,000)	(72,000)
Principal payments on debt	(1,139)	(1,891)

Proceeds from issuance of common stock	310	4,414
Repurchase of common stock		(22,107)
Excess tax benefits from share-based compensation arrangements	59	2,528
Change in book overdraft	5,490	3,708
Cash flows used in financing activities	(26,280)	(10,348)
Net decrease in cash and cash equivalents	(26,099)	(305)
Cash and cash equivalents at beginning of period	47,884	15,702
Cash and cash equivalents at end of period	$ 21,785	$ 15,397

See accompanying notes to condensed consolidated financial statements.

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of operations Founded in 1951, Jack in the Box Inc. (the Company) operates and franchises Jack in the Box® quick-service restaurants and Qdoba Mexican Grill® (Qdoba) fast-casual restaurants in 45 states. References to the Company throughout these notes to the condensed consolidated financial statements are made using the first person notations of we, us and our.

Basis of presentation The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles and the rules and regulations of the Securities and Exchange Commission (SEC). In our opinion, all adjustments considered necessary for a fair presentation of financial condition and results of operations for these interim periods have been included. Operating results for one interim period are not necessarily indicative of the results for any other interim period or for the full year.

The condensed consolidated financial statements include the accounts of the Company, its wholly-owned subsidiaries and any variable interest entities where the Company is deemed the primary beneficiary. All significant intercompany transactions are eliminated.

These financial statements should be read in conjunction with the consolidated financial statements and related notes contained in our Annual Report on Form 10-K for the fiscal year ended September 28, 2008. The accounting policies used in preparing these condensed consolidated financial statements are the same as those described in our Form 10-K, with the exception of new accounting pronouncements adopted in fiscal 2009.

Reclassifications and adjustments Certain prior year amounts in the condensed consolidated financial statements have been reclassified to conform to the fiscal 2009 presentation. In the fourth quarter of 2008, our Board of Directors approved plans to sell our Quick Stuff® convenience stores. As such, Quick Stuff operations have been presented as discontinued operations for all periods presented. Refer to Note 2, *Discontinued Operations*, for additional information.

Fiscal year Our fiscal year is 52 or 53 weeks ending the Sunday closest to September 30. Fiscal years 2009 and 2008 include 52 weeks. Our first quarter includes 16 weeks and all other quarters include 12 weeks. All comparisons between 2009 and 2008 refer to the 16-week (quarter) periods ended January 18, 2009 and January 20, 2008, respectively, unless otherwise indicated.

Use of estimates In preparing the condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles, management is required to make certain assumptions and estimates that affect reported amounts of assets, liabilities, revenues, expenses and the disclosure of contingencies. In making these assumptions and estimates, management may from time to time seek advice and consider information provided by actuaries and other experts in a particular area. Actual amounts could differ materially from these estimates.

Company-owned life insurance We have purchased company-owned life insurance (COLI) policies to support our non-qualified benefit plans. The cash surrender values of these policies were $54.4 million and $65.3 million as of January 18, 2009 and September 28, 2008, respectively, and are included in other assets, net in the accompanying condensed consolidated balance sheets. These policies reside in an umbrella trust for use only to pay plan benefits to participants or to pay creditors if the Company becomes insolvent. As of January 18, 2009 and September 28, 2008, the trust also included cash of $1.4 million. During the quarter ended January 18, 2009, we incurred losses on our COLI policies of $12.0 million due to continued declines in the stock market, which were offset in part by a $6.3 million fair value adjustment to our non-qualified deferred compensation plan obligation.

Assets held for sale Assets held for sale, which typically represent the costs for sites that we plan to sell and lease back, also include the net book value of equipment we plan to sell to franchisees and assets expected to be sold upon our disposition of Quick Stuff. Assets held for sale were as follows at the end of each reporting period (*in thousands*):

	January 18, 2009	September 28, 2008
Sites held for sale and leaseback	$ 76,712	$ 62,309
Quick Stuff assets held for sale (Note 2)	48,054	49,656
Assets held for sale to franchisees	987	1,029
Assets held for sale	$ 125,753	$ 112,994

6

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Franchise arrangements Franchise arrangements generally provide for initial franchise fees, which are included in franchised restaurant revenues in the accompanying condensed consolidated statements of earnings. In addition to initial franchise fees, we also recognize gains on the sale of company-operated restaurants to franchisees. Gains on the sale of restaurant businesses to franchisees are recorded when the sales are consummated, and certain other gain recognition criteria are met. The following is a summary of these transactions (*dollars in thousands*):

	Sixteen Weeks Ended	
	January 18, 2009	**January 20, 2008**
Number of restaurants sold to franchisees	29	28
Number of restaurants opened by franchisees	19	25
Initial fanchise fees received	$ 1,955	$ 2,023
Cash proceeds from the sale of company-operated restaurants	$ 18,620	$ 21,935
Notes receivable	5,293	
Net assets sold (primarily property and equipment)	(5,041)	(5,130)
Goodwill related to the sale of company-operated restaurants	(511)	(456)
Gains on the sale of company-operated restaurants	$ 18,361	$ 16,349

New accounting pronouncements adopted In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) 157, *Fair Value Measurements*. SFAS 157 clarifies the definition of fair value, describes methods used to appropriately measure fair value, and expands fair value disclosure requirements. On September 29, 2008, we adopted the provisions of SFAS 157 for our financial assets and liabilities and elected the deferral option for our non-financial assets and liabilities. The adoption of this statement did not have a material impact on our condensed consolidated financial statements.

The following table presents the financial assets and liabilities measured at fair value on a recurring basis as of January 18, 2009 summarized by SFAS 157 valuation hierarchy (*in thousands*):

		Fair Value Measurements		
	January 18, 2009	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Natural gas derivatives (1)	$ 657	$ 657	$	$

Interest rate swaps (2)	9,010		9,010	
Non-qualified deferred compensation plan (3)	31,071	31,071		
Total liabilities at fair value	$ 40,738	$ 31,728	$ 9,010	$

(1) From time to time, we use natural gas derivatives to manage price fluctuations related to unpredictable factors such as weather and various market conditions outside of our control. At the end of the quarter, we had two monthly natural gas swap agreements in place that represent approximately 42% of our total requirements for natural gas for the months of February and March. The fair value of our natural gas derivative contracts are based on the closing futures price of our contracts.

(2) We have entered interest rate swaps to reduce our exposure to rising interest rates on our variable debt.

The fair value of our interest rate swaps are based upon valuation models as reported by our counterparties.

(3) We maintain an unfunded defined contribution plan for key executives and other members of management excluded from participation in our qualified savings plan. The fair value of this obligation is based on the closing market prices of the participants elected investments.

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

In September 2006, the FASB issued SFAS 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106 and 132(R)*. In fiscal 2007, we adopted the recognition provisions of SFAS 158, which required recognition of the overfunded or underfunded status of a defined benefit plan as an asset or liability. SFAS 158 also requires that we change the annual date we use to measure our plan assets and benefit obligations from June 30 to the end of our fiscal year. We adopted the measurement date provisions on September 29, 2008 using the alternative transition method based on a 15-month projection derived from plan asset and benefit obligation measurements as of June 30, 2008. Adoption of the measurement date provisions will result in a reduction of $3.0 million to beginning retained earnings at the end of the fiscal year representing 3/15ths of the periodic benefit costs for the period June 30, 2008 to September 27, 2009. The remaining 12/15ths of the periodic benefit costs will be recognized during fiscal 2009. Refer to Note 6, *Retirement Plans*, for additional disclosure regarding our defined benefit and postretirement plans.

In February 2007, the FASB issued SFAS 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS 159 permits entities to voluntarily choose to measure many financial instruments and certain other items at fair value. We adopted SFAS 159 on September 29, 2008. We did not elect to begin reporting any financial assets or financial liabilities at fair value upon adoption of SFAS 159. In addition, we did not elect to report at fair value any new financial assets or financial liabilities entered into during the quarter ended January 18, 2009.

In December 2008, the FASB issued FASB Staff Position (FSP) FAS 140-4 and FIN 46R-8, *Disclosures by Public Entities (Enterprises) about Transfers of Financial Assets and Interests in Variable Interest Entities,* which is effective for the first reporting period ending after December 15, 2008. This FSP requires additional disclosures related to variable interest entities (VIEs) in accordance with SFAS 140 and FIN 46R. We adopted this FSP as of September 29, 2008 and the required disclosures are provided below.

The primary entities in which we possess a variable interest are franchise entities, which operate our franchised restaurants. We do not possess any ownership interests in franchise entities. We have reviewed these franchise entities and determined that we are not the primary beneficiary of the entities and therefore, these entities have not been consolidated.

We use advertising funds for both our restaurant concepts to administer our advertising programs. These funds are consolidated into our financial statements as they are deemed VIEs for which we are the primary beneficiary. Contributions to these funds are designed for advertising, and we administer the funds contributions. The Company s maximum loss exposure for these funds is limited to its investment.

The following table reflects the assets and liabilities of these VIEs that were included in our consolidated balance sheet at January 18, 2009 (*in thousands*):

	Jack in the Box	Qdoba
Cash	$	$ 2,156
Accounts receivable		121
Prepaid assets	5,294	41
Other		8
Total assets	$ 5,294	$ 2,326

Accounts payable	$		$	313
Accrued expenses		25,058		2,013
Total liabilities	$	25,058	$	2,326

2. DISCONTINUED OPERATIONS

We operate a proprietary chain of convenience stores called Quick Stuff, with 61 locations, each built adjacent to a full-size Jack in the Box restaurant and including a major-brand fuel station. In the fourth quarter of 2008, our Board of Directors approved a plan to sell Quick Stuff to maximize the potential of the Jack in the Box and Qdoba brands.

We expect to sell this business within fiscal 2009 and do not expect this sale to have a material impact on ongoing earnings. In accordance with the provisions of SFAS 144, *Accounting for the Impairment or Disposal of Long-lived Assets*, the results of operations of Quick Stuff for all periods presented have been reported as discontinued operations.

Table of Contents

JACK IN THE BOX INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The major classes of Quick Stuff assets held for sale were as follows at the end of each reporting period (*in thousands*):

	January 18, 2009	September 28, 2008
Assets held for sale:		
Inventories	$ 5,222	$ 6,518
Property and equipment, net	41,527	41,827
Goodwill	912	912
Other assets, primarily liquor licenses	393	399
Total assets of discontinued operations	$ 48,054	$ 49,656

Revenue and operating income from discontinued operations in each period are as follows (*in thousands*):

	Sixteen Weeks Ended	
	January 18, 2009	January 20, 2008
Revenue	$92,940	$127,945
Earnings (losses) before income taxes	$ 717	$ (67)

3. ACQUISITIONS

We account for the acquisition of franchised restaurants using the purchase method of accounting pursuant to SFAS 141, *Business Combinations*. During the quarter ended January 18, 2009, we acquired 22 Qdoba restaurants from franchisees for net consideration of $6.8 million. The total purchase was allocated to property and equipment, goodwill and other income.

4. RESTAURANT CLOSING, IMPAIRMENT CHARGES AND OTHER

In 2009 and 2008, we recorded impairment charges of $1.7 million and $1.4 million, respectively, primarily related to the write-down of the carrying value of Jack in the Box restaurants we continue to operate. We also recognized accelerated depreciation and other costs on the disposition of property and equipment of $4.4 million and $5.2 million, respectively, primarily related to our restaurant re-image program, which includes a major renovation of our restaurant facilities, normal ongoing capital maintenance activities, and, in 2008, a kitchen enhancement project.

These impairment charges, accelerated depreciation and other costs on the disposition of property and equipment are included in selling, general and administrative expenses in the accompanying condensed consolidated statements of earnings.

Total accrued restaurant closing costs, included in accrued expenses and other long-term liabilities, changed as follows during 2009 and 2008 (*in thousands*):

	Sixteen Weeks Ended
	January 20,

	January 18, 2009	2008
Balance at beginning of period	$ 4,712	$ 5,451
Additions and adjustments	477	286
Cash payments	(389)	(322)
Balance at end of period	$ 4,800	$ 5,415

Additions and adjustments primarily relate to revisions to certain sublease assumptions in 2009 and 2008, and the closure of two Jack in the Box restaurants in 2008.

5. INCOME TAXES

The income tax provisions reflect effective tax rates of 40.0% in 2009 and 37.7% in 2008. The final annual tax rate cannot be determined until the end of the fiscal year; therefore, the actual rate could differ from our current estimates.

Table of Contents

New Accounting Standards

Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income

In February 2013, the Financial Accounting Standards Board amended guidance that requires disclosure for amounts reclassified out of accumulated other comprehensive income (AOCI) by component. The amendments require the presentation of amounts reclassified out of AOCI by the respective line items of net income if the amount reclassified is required to be reclassified to net income in its entirety in the reporting period. For amounts that are not required to be reclassified in their entirety to net income, a cross-reference to other disclosures that provide additional detail about those amounts is required. This guidance is effective prospectively for interim and annual reporting periods beginning after December 15, 2012. The adoption of this guidance did not have an impact on our condensed consolidated unaudited financial statements.

2. EARNINGS PER SHARE

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

Quarters Ended March 31,	**2013**	2012
Basic Earnings per Share:		
Net income attributable to Watsco, Inc. shareholders	**$ 13,385**	$ 8,466
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	**937**	1,408
Earnings allocated to Watsco, Inc. shareholders	**$ 12,448**	$ 7,058
Weighted-average Common and Class B common shares outstanding for basic earnings per share	**32,157,729**	30,756,626
Basic earnings per share for Common and Class B common stock	**$ 0.39**	$ 0.23
Allocation of earnings for Basic:		
Common stock	**$ 11,401**	$ 6,405
Class B common stock	**1,047**	653
	$ 12,448	$ 7,058
Diluted Earnings per Share:		
Net income attributable to Watsco, Inc. shareholders	**$ 13,385**	$ 8,466
Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock	**937**	1,408
Earnings allocated to Watsco, Inc. shareholders	**$ 12,448**	$ 7,058
Weighted-average Common and Class B common shares outstanding for basic earnings per share	**32,157,729**	30,756,626
Effect of dilutive stock options	**55,711**	77,842
Weighted-average Common and Class B common shares outstanding for diluted earnings per share	**32,213,440**	30,834,468
Diluted earnings per share for Common and Class B common stock	**$ 0.39**	$ 0.23

Diluted earnings per share for our Common stock assumes the conversion of all of our Class B common stock into Common stock as of the beginning of the fiscal year and adjusts for the dilutive effects of outstanding stock options using the treasury stock method; therefore, no allocation of earnings to Class B common stock is required. As of March 31, 2013 and 2012, our outstanding Class B common stock was convertible into 2,705,465 and 2,846,334 shares of our Common stock, respectively.

No shares were excluded from diluted earnings per share for either the quarter ended March 31, 2013 or 2012.

3. OTHER COMPREHENSIVE (LOSS) INCOME

Other comprehensive (loss) income consists of the currency translation adjustment associated with our Canadian operations use of the Canadian dollar as their functional currency and changes in the unrealized gain on available-for-sale securities. The tax effects allocated to each component of other comprehensive (loss) income are as follows:

Quarters Ended March 31,	**2013**	**2012**
Foreign currency translation adjustment	**$ (2,885)**	$

Unrealized gain on available-for-sale securities	**14**	25
Income tax expense	**(6)**	(9)
Unrealized gain on available-for-sale securities, net of tax	**8**	16
Other comprehensive (loss) income	**$ (2,877)**	$ 16

The changes in accumulated other comprehensive loss, net of tax, are as follows:

Quarters Ended March 31,	2013	2012
Foreign currency translation adjustment:		
Beginning balance	**$ (1,785)**	$
Current period other comprehensive loss	**(2,885)**	
Ending balance	**(4,670)**	
Available-for-sale securities:		
Beginning balance	**(317)**	(352)
Current period other comprehensive income	**8**	16
Ending balance	**(309)**	(336)
Accumulated other comprehensive loss, net of tax	**$ (4,979)**	$ (336)

4. DERIVATIVE FINANCIAL INSTRUMENTS

We routinely use certain derivative instruments to hedge foreign currency exposure. Although these derivatives were not designated as hedges and/or did not qualify for hedge accounting, they were effective economic hedges. The changes in fair value of economic hedges are recognized in earnings. During 2012, we entered into foreign currency forward contracts to offset the earnings impact that foreign currency exchange rate fluctuations would otherwise have on certain monetary liabilities that are denominated in nonfunctional currencies. The change in fair value of these foreign currency forward contracts was $21 for the quarter ended March 31, 2013, and is included in selling, general and administrative expenses in our condensed consolidated unaudited statement of income. The total notional value of our foreign currency exchange contracts as of March 31, 2013 was $31,690, and such contracts have varying terms expiring through June 2013. See Note 5.

5. FAIR VALUE MEASUREMENTS

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

Description	Fair Value at March 31, 2013	Fair Value Measurements at March 31, 2013 Using Level 1	Level 2	Level 3
Assets:				
Available-for-sale securities	**$ 240**	**$ 240**		
Liabilities:				
Derivative financial instruments	**$ 176**		**$ 176**	

Description	Fair Value at December 31, 2012	Fair Value Measurements at December 31, 2012 Using Level 1	Level 2	Level 3
Assets:				
Available-for-sale securities	$ 226	$ 226		
Liabilities:				
Derivative financial instruments	$ 197		$ 197	

The following is a description of the valuation techniques used for these assets and liabilities, as well as the level of input used to measure fair value:

Available-for-sale securities the investments are exchange-traded equity securities. Fair values for these investments are based on closing stock prices from active markets and are therefore classified within Level 1 of the fair value hierarchy. The fair value of available-for-sale securities is included in other assets in our condensed consolidated balance sheets.

Derivative financial instruments the derivatives are foreign currency forward contracts. Fair value is based on observable market inputs, such as forward rates, in active markets and therefore the derivatives are classified within Level 2 of the valuation hierarchy.

The fair value of the derivative financial instruments is included in accrued expenses and other current liabilities in our condensed consolidated balance sheet.

There were no transfers in or out of Level 1 and Level 2 during the quarter ended March 31, 2013.

6. ACQUISITIONS

Carrier Enterprise I

Carrier Enterprise, LLC (Carrier Enterprise I) is a joint venture formed on July 1, 2009 with Carrier that operates a network of locations primarily throughout the U.S. Sun Belt. From its inception until July 2, 2012, we owned 60% of the joint venture and Carrier owned 40%. We had an option to purchase an additional 10% ownership interest in Carrier Enterprise I, which became exercisable on July 1, 2012. On July 2, 2012, we exercised this option and acquired an additional 10% ownership interest in Carrier Enterprise I for cash consideration of $51,881. We have a second option to purchase an additional 10% interest in Carrier Enterprise I, which becomes exercisable beginning on July 1, 2014.

Carrier Enterprise II

In 2011, we formed a second joint venture with Carrier and completed two additional transactions. In April 2011, Carrier contributed 28 of its company-owned locations in eight Northeast U.S. states, and we contributed 14 locations in the Northeast U.S. In July 2011, we purchased Carrier s distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have a 60% controlling interest in Carrier Enterprise II, and Carrier has a 40% noncontrolling interest. Neither we nor Carrier have any options to purchase additional ownership interests in Carrier Enterprise II.

Carrier Enterprise III

In April 2012, we formed a joint venture, Carrier Enterprise Canada, L.P. (Carrier Enterprise III), with UTC Canada Corporation (UTC Canada), an affiliate of Carrier, to distribute Carrier, Bryant and Payne branded residential, light-commercial and commercial applied HVAC products in Canada. We have a 60% controlling interest in Carrier Enterprise III, and Carrier has a 40% noncontrolling interest. Neither we nor UTC Canada have any options to purchase additional ownership interests in Carrier Enterprise III.

The unaudited pro forma financial information, combining our results of operations with the operations of Carrier Enterprise III as if the joint venture had been consummated on January 1, 2012, is as follows:

Quarter ended March 31,	**2012**
Revenues	$ 703,977
Net income	13,106
Less: net income attributable to noncontrolling interest	4,850
Net income attributable to Watsco, Inc.	$ 8,256
Diluted earnings per share for Common and Class B common stock	$ 0.21

This unaudited pro forma financial information is presented for informational purposes only. The unaudited pro forma financial information for the period presented includes adjustments to record income taxes related to our portion of Carrier Enterprise III s income, amortization related to identified intangible assets with finite lives and interest expense on borrowings incurred to acquire our 60% controlling interest. This unaudited pro forma financial information does not include adjustments to add or remove certain corporate expenses of Carrier Enterprise III, which may or may not be incurred in future periods, or adjustments for depreciation or synergies that may be realized subsequent to the acquisition date. This unaudited pro forma financial information does not necessarily reflect our future results of operations or what the results of operations would have been had we acquired our 60% controlling interest in and operated Carrier Enterprise III as of the beginning of the period presented.

7. SHAREHOLDERS EQUITY

Common Stock Dividends

We paid cash dividends of $0.25 and $0.62 per share of Common stock and Class B common stock during the quarters ended March 31, 2013 and 2012, respectively.

Non-Vested (Restricted) Stock

During the quarters ended March 31, 2013 and 2012, we granted 90,543 and 58,301 shares of non-vested (restricted) stock, respectively.

Stock Options

During the quarters ended March 31, 2013 and 2012, 7,000 and 21,500, respectively, of stock options were exercised for Common stock. Cash received from Common stock issued upon the exercise of stock options during the quarters ended March 31, 2013 and 2012, was $338 and $987, respectively.

Employee Stock Purchase Plan

During the quarters ended March 31, 2013 and 2012, 2,182 and 2,962 shares of Common stock were issued under our employee stock purchase plan, respectively, for which we received net proceeds of $159 and $194, respectively.

401(k) Plan

During the quarters ended March 31, 2013 and 2012, 22,551 and 26,991 shares of Common stock were issued to our profit sharing retirement plan, respectively, representing discretionary matching contribution of $1,689 and $1,772, respectively.

Noncontrolling Interest

We have a 60% controlling interest in both Carrier Enterprise II and Carrier Enterprise III, and Carrier has a 40% noncontrolling interest in each. Effective July 2, 2012, our controlling interest in Carrier Enterprise I increased to 70% from 60%, following our exercise of the option described in Note 6. The following table reconciles shareholders equity attributable to Carrier s noncontrolling interest:

Noncontrolling interest at December 31, 2012	$ 273,826
Net income attributable to noncontrolling interest	7,704
Foreign currency translation adjustment	(2,178)
Noncontrolling interest at March 31, 2013	**$ 279,352**

8. COMMITMENTS AND CONTINGENCIES

Litigation, Claims and Assessments

We are involved in litigation incidental to the operation of our business. We vigorously defend all matters in which we or our subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments that may affect us. Although the adequacy of existing insurance coverage and the outcome of any legal proceedings cannot be predicted with certainty, based on the current information available, we do not believe the ultimate liability associated with any known claims or litigation will have a material adverse effect on our financial condition or results of operations.

Self-Insurance

Self-insurance reserves are maintained relative to company-wide casualty insurance and health benefit programs. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverage. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occur and exceed these estimates, additional reserves may be required. The estimation process contains uncertainty since management must use judgment to estimate the ultimate cost that will be incurred to settle reported claims and unreported claims for incidents incurred but not reported as of the balance sheet date. Reserves in the amounts of $5,308 and $4,844 at March 31, 2013 and December 31, 2012, respectively, were established related to such insurance programs and are included in accrued expenses and other current liabilities in our condensed consolidated balance sheets.

9. RELATED PARTY TRANSACTIONS

Purchases from Carrier and its affiliates comprised 55% and 52% of all purchases made during the quarters ended March 31, 2013 and 2012, respectively. At March 31, 2013 and December 31, 2012, approximately $126,000 and $62,000, respectively, was payable to Carrier and its affiliates, net of receivables. Our joint ventures with Carrier also sell HVAC products to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statements of income for the quarters ended March 31, 2013 and 2012 include $5,295 and $6,784, respectively, of sales to Carrier and its affiliates. We believe these transactions are conducted at arm s-length in the ordinary course of business.

Carrier Enterprise II entered into Transactional Services Agreements (TSAs) with Carrier, pursuant to which Carrier performed certain business processes on its behalf, including processes involving the use of certain information technologies. The services provided by Carrier pursuant to the TSAs terminated on April 30, 2012. The fees related to these TSAs were $584 for the quarter ended March 31, 2012 and are included in selling, general and administrative expenses in our condensed consolidated unaudited statement of income. At December 31, 2012, $25 related to theses TSAs was payable to Carrier and was included in accrued expenses and other current liabilities in our condensed consolidated unaudited balance sheet.

Carrier Enterprise III entered into TSAs with UTC Canada, pursuant to which UTC Canada performs certain business processes on behalf of Carrier Enterprise III, including processes involving the use of certain information technologies, and UTC Canada entered into TSAs with Carrier Enterprise III, pursuant to which Carrier Enterprise III performs certain business processes on behalf of UTC Canada. The services provided pursuant to the TSAs terminate on various dates but may be extended as agreed upon by the parties. The fees payable by Carrier Enterprise III to UTC Canada under one TSA were substantially offset by the fees payable to Carrier Enterprise III by UTC Canada under the other TSA.

At December 31, 2012, $29,637 was payable to Carrier and UTC Canada for unpaid distributions declared to the noncontrolling interest. This amount was paid to Carrier and UTC Canada in February 2013.

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

This Quarterly Report contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions and/or joint ventures, (iv) financing plans and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based largely on management s current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including, but not limited to:

- general economic conditions;
- competitive factors within the HVAC/R industry;
- effects of supplier concentration;
- fluctuations in certain commodity costs;
- consumer spending;
- consumer debt levels;
- new housing starts and completions;
- capital spending in the commercial construction market;
- access to liquidity needed for operations;

- seasonal nature of product sales;
- weather conditions;
- insurance coverage risks;
- federal, state and local regulations impacting our industry and products;
- prevailing interest rates;
- foreign currency exchange rate fluctuations;
- international political risk; and
- the continued viability of our business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if realized, in whole or in part, that the information will have the expected consequences to, or effects on, our business or operations. For additional information identifying other important factors that may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, see our SEC filings, including but not limited to, the discussion included in Item 1A Risk Factors of our 2012 Annual Report on Form 10-K. Forward-looking statements speak only as of the date the statement was made. We assume no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as required by applicable law.

The following information should be read in conjunction with the condensed consolidated unaudited financial statements and notes thereto included under Item 1 of this Quarterly Report on Form 10-Q. In addition, reference should be made to our audited consolidated financial statements and notes thereto and related Management s Discussion and Analysis of Financial Condition and Results of Operations included in our 2012 Annual Report on Form 10-K.

Company Overview

Watsco, Inc. and its subsidiaries (collectively, Watsco, or *we, us* or *our*) was incorporated in Florida in 1956 and is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies (HVAC/R) in the HVAC/R distribution industry. At March 31, 2013, we operated from 574 locations in 38 U.S. states, Canada, Mexico and Puerto Rico with additional market coverage on an export basis to Latin America and the Caribbean.

Revenues primarily consist of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. Selling, general and administrative expenses primarily consist of selling expenses, the largest components of which are salaries, commissions and marketing expenses that are variable and correlate to changes in sales. Other significant selling, general and administrative expenses relate to the operation of warehouse facilities, including a fleet of trucks and forklifts and facility rent, which are payable mostly under non-cancelable operating leases.

Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on weather patterns during summer and winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment usually highest in the fourth quarter. Demand related to the new construction sectors throughout most of the markets is fairly consistent during the year, except for dependence on housing completions and related weather and economic conditions.

Joint Ventures with Carrier Corporation

In 2009, we formed a joint venture with Carrier Corporation (Carrier), which we refer to as Carrier Enterprise I, in which Carrier contributed 95 of its company-owned locations in 13 U.S. Sun Belt states and Puerto Rico and its export division in Miami, Florida, and we contributed 15 locations that distributed Carrier products. On July 2, 2012, we exercised our option to acquire an additional 10% ownership interest in Carrier Enterprise I, which increased our ownership interest to 70%. We have an option to purchase from Carrier an additional 10% interest in Carrier Enterprise I, which becomes exercisable in July 2014.

In 2011, we formed a second joint venture with Carrier and completed two additional transactions. In April 2011, Carrier contributed 28 of its company-owned locations in eight Northeast U.S. states, and we contributed 14 locations in the Northeast U.S. In July 2011, we purchased Carrier s distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have a 60% controlling interest in Carrier Enterprise II, and Carrier has a 40% noncontrolling interest. Neither we nor Carrier have any options to purchase additional ownership interests in Carrier Enterprise II.

In April 2012, we formed a third joint venture, which we refer to as Carrier Enterprise III, with UTC Canada Corporation, referred to as UTC Canada, an affiliate of Carrier. Carrier contributed 35 of its company-owned locations in Canada to Carrier Enterprise III. We have a 60% controlling interest in Carrier Enterprise III, and UTC Canada has a 40% noncontrolling interest. Neither we nor UTC Canada have any options to purchase additional ownership interests in Carrier Enterprise III.

Critical Accounting Policies

Management s discussion and analysis of financial condition and results of operations is based upon the condensed consolidated unaudited financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the condensed consolidated unaudited financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. At least quarterly, management reevaluates its judgments and estimates, which are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances.

Our critical accounting policies are included in our 2012 Annual Report on Form 10-K as filed on February 28, 2013. We believe that there have been no significant changes during the quarter ended March 31, 2013 to the critical accounting policies disclosed in our 2012 Annual Report on Form 10-K.

Recent Accounting Pronouncements

Refer to Note 1 to our condensed consolidated unaudited financial statements included in this Quarterly Report on Form 10-Q for a discussion of new accounting standards.

Results of Operations

The following table summarizes information derived from the condensed consolidated unaudited statements of income expressed as a percentage of revenues for the quarters ended March 31, 2013 and 2012:

	2013	2012
Revenues	**100.0%**	100.0%
Cost of sales	**75.4**	76.2
Gross profit	**24.6**	23.8
Selling, general and administrative expenses	**20.3**	20.6
Operating income	**4.3**	3.2
Interest expense, net	**0.2**	0.2
Income before income taxes	**4.1**	3.0
Income taxes	**1.1**	0.9
Net income	**3.0**	2.1
Less: net income attributable to noncontrolling interest	**1.1**	0.8
Net income attributable to Watsco, Inc.	**1.9%**	1.3%

The following narratives include the results of operations for businesses acquired during 2012. The results of operations for these acquisitions have been included in our condensed consolidated unaudited statements of income beginning on their respective dates of acquisition. See Note 6 to our condensed consolidated unaudited financial statements included in this Quarterly Report on Form 10-Q for the pro forma financial information combining our results of operations with the operations of Carrier Enterprise III. The following narratives also reflect our acquisition of an additional 10% ownership interest in Carrier Enterprise I effective July 2, 2012. There were no businesses acquired during the first quarter of 2013.

In the following narratives, computations and disclosure information referring to same-store basis exclude the effects of locations acquired or locations opened or closed during the immediately preceding 12 months unless they are within close geographical proximity to existing locations. At March 31, 2013 and 2012, 61 and 65 locations, respectively, were excluded from same-store basis information. The table below summarizes the changes in our locations for the 12 months ended March 31, 2013:

	Number of Locations
March 31, 2012	541
Acquired	35
Opened	10
Closed	(13)
December 31, 2012	573
Opened	2
Closed	(1)
March 31, 2013	**574**

Revenues

Revenues for the first quarter of 2013 increased $80.1 million, or 13%, compared to the first quarter of 2012, including $62.5 million attributable to the 35 new Carrier Enterprise III locations acquired in 2012 and $0.6 million from other locations opened during the preceding 12 months, partially offset by $1.0 million from locations closed. On a same-store basis, revenues increased $18.0 million, or 3%, as compared to the same period in 2012, reflecting a 3% increase in sales of HVAC equipment (6% increase in residential HVAC equipment offset by a 5% decrease in commercial HVAC equipment), a 1% increase in sales of other HVAC products and a 7% increase in sales of commercial refrigeration products. Sales of residential HVAC equipment benefited from an improved sales mix of higher-efficiency air conditioning and heating systems, which sell at higher unit prices.

Gross Profit

Gross profit for the quarter ended March 31, 2013 increased $24.8 million, or 16%, compared to the same period in 2012, primarily as a result of increased revenues. Gross profit margin for the quarter ended March 31, 2013 improved 80 basis-points to 24.6% versus 23.8% for the same period in 2012, primarily due to increased average selling prices for residential HVAC equipment, higher margins on a better sales mix of higher-efficiency air conditioning and heating systems and reflecting higher gross margins achieved by Carrier Enterprise III.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the first quarter of 2013 increased $14.2 million, or 11%, compared to the first quarter of 2012 primarily due to increased revenues. Selling, general and administrative expenses as a percent of revenues for the quarter ended March 31, 2013 decreased to 20.3% versus 20.6% for the same period in 2012. The decrease in selling, general, and administrative expenses as a percentage of revenues was primarily due to leveraging of fixed operating costs as compared to 2012. On a same-store basis, selling, general and administrative expenses were flat as compared to the same period in 2012.

Interest Expense, Net

Net interest expense for the quarter ended March 31, 2013 increased $0.3 million, or 33%, compared to the same period in 2012, primarily as a result of an increase in average outstanding borrowings, partially offset by a lower effective interest rate in 2013 as compared to 2012.

Income Taxes

Income taxes increased to $8.3 million for the first quarter of 2013 as compared to $5.5 million for the first quarter of 2012 and are a composite of the income taxes attributable to our wholly owned operations and investments, and income taxes attributable to the Carrier joint ventures, which are taxed as partnerships for income tax purposes. The effective income tax rate attributable to us was 36.75% and 37.5% for the quarters ended March 31, 2013 and 2012, respectively. The decrease was primarily due to lower effective tax rates for income generated by our foreign subsidiaries.

Net Income Attributable to Watsco, Inc.

Net income attributable to Watsco for the quarter ended March 31, 2013 increased $4.9 million, or 58%, compared to the same period in 2012. The increase was primarily driven by higher revenues, expanded profit margins and reduced selling, general and administrative expenses as a percent of revenues, as discussed above, and by our acquisition of an additional 10% ownership interest in Carrier Enterprise I in July 2012.

Liquidity and Capital Resources

We assess our liquidity in terms of our ability to generate cash to execute our business strategy and fund operating and investing activities, taking into consideration the seasonal demand of HVAC/R products, which peaks in the months of May through August. Significant factors that could affect our liquidity include the following:

- cash flows generated from operating activities;
- the adequacy of our available bank line of credit;
- the ability to attract long-term capital with satisfactory terms;
- acquisitions;
- dividend payments;
- capital expenditures; and