

COMFORT SYSTEMS USA INC  
Form 10-Q  
October 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 September 30, 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 76 0526487  
(State or other jurisdiction of (I.R.S. Employer  
Incorporation or Organization) Identification No.)  
675 Bering Drive  
Suite 400  
Houston, Texas 77057  
(Address of Principal Executive Offices) (Zip  
Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non accelerated filer, 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 company  
(Do not check if a  
smaller reporting company)

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 October 21, 2016 was 37,209,358 (excluding treasury shares of 3,914,007).

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COMFORT SYSTEMS USA, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts)

|   | September<br>30,<br>2016<br>(Unaudited) | December<br>31,<br>2015 |
|---|---|-------------------------|
| <b>ASSETS</b>   |   |                         |
| <b>CURRENT ASSETS:</b>  |   |                         |
| Cash and cash equivalents   | \$ 25,337                               | \$ 56,464               |
| Accounts receivable, less allowance for doubtful accounts of \$4,909 and \$5,158, respectively                | 331,111                                 | 302,052                 |
| Other receivables   | 13,319                                  | 20,642                  |
| Inventories   | 9,719                                   | 7,941                   |
| Prepaid expenses and other  | 7,139                                   | 5,836                   |
| Costs and estimated earnings in excess of billings  | 36,239                                  | 31,338                  |
| Total current assets  | 422,864                                 | 424,273                 |
| <br>  |   |                         |
| PROPERTY AND EQUIPMENT, NET   | 66,490                                  | 60,813                  |
| GOODWILL  | 148,140                                 | 143,874                 |
| IDENTIFIABLE INTANGIBLE ASSETS, NET   | 44,993                                  | 41,079                  |
| DEFERRED INCOME TAX ASSETS  | 29,187                                  | 16,276                  |
| OTHER NONCURRENT ASSETS   | 6,068                                   | 5,279                   |
| Total assets  | \$ 717,742                              | \$ 691,594              |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>   |   |                         |
| <b>CURRENT LIABILITIES:</b>   |   |                         |
| Current maturities of long-term debt  | \$ 100                                  | \$ 500                  |
| Current maturities of long-term capital lease obligations   | 190                                     | 251                     |
| Accounts payable  | 106,165                                 | 106,684                 |
| Accrued compensation and benefits   | 60,200                                  | 54,079                  |
| Billings in excess of costs and estimated earnings  | 81,408                                  | 85,397                  |
| Accrued self-insurance  | 29,280                                  | 29,803                  |
| Other current liabilities   | 36,355                                  | 28,677                  |
| Total current liabilities   | 313,698                                 | 305,391                 |
| LONG-TERM DEBT  | 27,480                                  | 10,500                  |
| LONG-TERM CAPITAL LEASE OBLIGATIONS   | 123                                     | 256                     |
| DEFERRED INCOME TAX LIABILITIES   | 1,810                                   | 1,810                   |
| OTHER LONG-TERM LIABILITIES   | 9,651                                   | 8,632                   |
| Total liabilities   | 352,762                                 | 326,589                 |
| <b>COMMITMENTS AND CONTINGENCIES</b>  |   |                         |
| <b>STOCKHOLDERS' EQUITY:</b>  |   |                         |
| Preferred stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding                          | —                                       | —                       |
| Common stock, \$.01 par, 102,969,912 shares authorized, 41,123,365 and 41,123,365 shares issued, respectively | 411                                     | 411                     |

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|   |            |            |
|---|------------|------------|
| Treasury stock, at cost, 3,893,129 and 3,696,781 shares, respectively | (56,079)   | (46,845)   |
| Additional paid-in capital  | 310,930    | 323,765    |
| Retained earnings   | 109,718    | 69,390     |
| Comfort Systems USA, Inc. stockholders' equity                        | 364,980    | 346,721    |
| Noncontrolling interests  | —          | 18,284     |
| Total stockholders' equity  | 364,980    | 365,005    |
| Total liabilities and stockholders' equity                            | \$ 717,742 | \$ 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 |            | Nine Months Ended |              |
|--|--------------------|------------|-------------------|--------------|
|  | September 30,      |            | September 30,     |              |
|  | 2016               | 2015       | 2016              | 2015         |
| REVENUE  | \$ 428,760         | \$ 410,565 | \$ 1,242,240      | \$ 1,196,679 |
| COST OF SERVICES   | 335,944            | 323,100    | 986,496           | 962,477      |
| Gross profit   | 92,816             | 87,465     | 255,744           | 234,202      |
| SELLING, GENERAL AND ADMINISTRATIVE EXPENSES                 | 61,032             | 57,902     | 180,245           | 168,967      |
| GAIN ON SALE OF ASSETS                                       | (166)              | (298)      | (523)             | (625)        |
| Operating income   | 31,950             | 29,861     | 76,022            | 65,860       |
| OTHER INCOME (EXPENSE):                                      |                    |            |                   |              |
| Interest income  | 3                  | —          | 6                 | 68           |
| Interest expense   | (563)              | (399)      | (1,870)           | (1,358)      |
| Changes in the fair value of contingent earn-out obligations | 804                | —          | 468               | 125          |
| Other  | 80                 | 37         | 455               | 64           |
| Other income (expense)                                       | 324                | (362)      | (941)             | (1,101)      |
| INCOME BEFORE INCOME TAXES                                   | 32,274             | 29,499     | 75,081            | 64,759       |
| INCOME TAX EXPENSE   | 11,803             | 9,613      | 27,052            | 22,202       |
| NET INCOME INCLUDING NONCONTROLLING INTERESTS                | 20,471             | 19,886     | 48,029            | 42,557       |
| Less: Net income attributable to noncontrolling interests    | —                  | 2,213      | —                 | 6,414        |
| NET INCOME ATTRIBUTABLE TO COMFORT SYSTEMS USA, INC.         | \$ 20,471          | \$ 17,673  | \$ 48,029         | \$ 36,143    |
| INCOME PER SHARE ATTRIBUTABLE TO COMFORT SYSTEMS USA, INC.:  |                    |            |                   |              |
| Basic  | \$ 0.55            | \$ 0.47    | \$ 1.28           | \$ 0.97      |
| Diluted  | \$ 0.54            | \$ 0.46    | \$ 1.27           | \$ 0.96      |
| SHARES USED IN COMPUTING INCOME PER SHARE:                   |                    |            |                   |              |
| Basic  | 37,360             | 37,552     | 37,380            | 37,431       |
| Diluted  | 37,821             | 38,007     | 37,854            | 37,844       |
| DIVIDENDS PER SHARE  | \$ 0.070           | \$ 0.065   | \$ 0.205          | \$ 0.185     |

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 | Retained  | Non-        | Total         |
|------------------|--------------|--------|----------------|-------------|------------|-----------|-------------|---------------|
|                  | Shares       | Amount | Shares         | Amount      | Paid-In    | Earnings  | Controlling | Stockholders' |
|                  |              |        |                |             | Capital    |           | Interests   | Equity        |
| 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   |              |        |                |             |            |           |             |               |
| interest         | —            | —      | —              | —           | —          | —         | (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       |



|   |            |        |             |             |            |            |          |            |
|---|------------|--------|-------------|-------------|------------|------------|----------|------------|
| Cumulative effect of change in accounting principle (unaudited)                           | —          | —      | —           | —           | —          | (38)       | —        | (38)       |
| Net income (unaudited)  | —          | —      | —           | —           | —          | 48,029     | —        | 48,029     |
| Issuance of Stock:  |            |        |             |             |            |            |          |            |
| Issuance of shares for options exercised (unaudited)                                      | —          | —      | 56,999      | 765         | (32)       | —          | —        | 733        |
| Issuance of restricted stock & performance stock (unaudited)                              | —          | —      | 172,727     | 2,282       | (306)      | —          | —        | 1,976      |
| Shares received in lieu of tax withholding payment on vested restricted stock (unaudited) | —          | —      | (41,788)    | (1,304)     | —          | —          | —        | (1,304)    |
| Stock-based compensation (unaudited)  | —          | —      | —           | —           | 3,024      | —          | —        | 3,024      |
| Dividends (unaudited)   | —          | —      | —           | —           | —          | (7,663)    | —        | (7,663)    |
| Acquisition of noncontrolling interests (unaudited)                                       | —          | —      | —           | —           | (15,521)   | —          | (18,284) | (33,805)   |
| Share repurchase (unaudited)  | —          | —      | (384,286)   | (10,977)    | —          | —          | —        | (10,977)   |
| BALANCE AT SEPTEMBER 30, 2016 (unaudited)   | 41,123,365 | \$ 411 | (3,893,129) | \$ (56,079) | \$ 310,930 | \$ 109,718 | \$ —     | \$ 364,980 |

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)

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2016                               | 2015      |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>  |                                    |           |
| Net income including noncontrolling interests   | \$ 48,029                          | \$ 42,557 |
| Adjustments to reconcile net income to net cash provided by operating activities—             |                                    |           |
| Amortization of identifiable intangible assets  | 6,227                              | 5,601     |
| Depreciation expense  | 13,444                             | 11,785    |
| Bad debt expense  | (177)                              | 1,132     |
| Deferred tax expense (benefit)  | (606)                              | (2,755)   |
| Amortization of debt financing costs  | 273                                | 238       |
| Gain on sale of assets  | (523)                              | (625)     |
| Changes in the fair value of contingent earn-out obligations                                  | (468)                              | (125)     |
| Stock-based compensation  | 3,868                              | 4,254     |
| Changes in operating assets and liabilities, net of effects of acquisitions and divestitures— |                                    |           |
| (Increase) decrease in—   |                                    |           |
| Receivables, net  | (4,301)                            | (1,283)   |
| Inventories   | (298)                              | (218)     |
| Prepaid expenses and other current assets   | (3,648)                            | 27        |
| Costs and estimated earnings in excess of billings  | (3,726)                            | (8,651)   |
| Other noncurrent assets   | (128)                              | (275)     |
| Increase (decrease) in—   |                                    |           |
| Accounts payable and accrued liabilities  | 1,628                              | 19,986    |
| Billings in excess of costs and estimated earnings  | (10,928)                           | 2,912     |
| Other long-term liabilities   | 1,088                              | 23        |
| Net cash provided by operating activities   | 49,754                             | 74,583    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>  |                                    |           |
| Purchases of property and equipment   | (17,257)                           | (15,216)  |
| Proceeds from sales of property and equipment   | 847                                | 891       |
| Cash paid for acquisitions, net of cash acquired  | (58,510)                           | (6,158)   |
| Net cash used in investing activities   | (74,920)                           | (20,483)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>  |                                    |           |
| Proceeds from revolving line of credit  | 144,000                            | 24,500    |
| Payments on revolving line of credit  | (129,000)                          | (53,000)  |
| Payments on other debt  | (567)                              | —         |
| Payments on capital lease obligations   | (194)                              | (277)     |
| Debt financing costs  | (789)                              | —         |
| Payments of dividends to stockholders   | (7,663)                            | (6,924)   |
| Share repurchase  | (10,977)                           | (4,930)   |

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|  |           |           |
|--|-----------|-----------|
| Shares received in lieu of tax withholding           | (1,304)   | (937)     |
| Excess tax benefit of stock-based compensation       | —         | 747       |
| Proceeds from exercise of options                    | 733       | 2,971     |
| Distributions to noncontrolling interests            | —         | (2,897)   |
| Payments for contingent consideration arrangements   | (200)     | (345)     |
| Net cash used in financing activities                | (5,961)   | (41,092)  |
| NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS | (31,127)  | 13,008    |
| CASH AND CASH EQUIVALENTS, beginning of period       | 56,464    | 32,064    |
| CASH AND CASH EQUIVALENTS, end of period             | \$ 25,337 | \$ 45,072 |

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

September 30, 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 39% of our consolidated 2016 revenue is attributable to installation of systems in newly constructed facilities, with the remaining 61% 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                                | \$ 930,694      | 75 %  |
| Plumbing                            | 181,824         | 15 %  |
| Building Automation Control Systems | 68,042          | 5 %   |
| Other                               | 61,680          | 5 %   |
| Total                               | \$ 1,242,240    | 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. Actual results could differ from those estimates. The most significant estimates used in our financial statements affect revenue and cost recognition for construction contracts, the allowance for doubtful accounts, self-insurance accruals, deferred tax assets, warranty accruals, fair value accounting for acquisitions and the quantification of fair value for reporting units in connection with our goodwill impairment testing.

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Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” ASU 2014-09 provides a framework that replaces the existing revenue recognition guidance. The guidance can be applied on a full retrospective or modified retrospective basis whereby the entity records a cumulative effect of initially applying this update 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 price 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. It is effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Entities should apply the new guidance prospectively with earlier application permitted as of the beginning of an interim or annual reporting period. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

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

In March 2016, the FASB issued ASU No. 2016-09, “Compensation—Stock Compensation (Topic 718)”. The standard changes certain aspects of accounting for share-based payments to employees. Specifically, the new guidance requires excess tax benefits and tax deficiencies to be recognized in the income statement instead of additional paid-in capital when the awards vest or are settled. Additionally, cash flows related to excess tax benefits will be presented as an operating activity rather than a financing activity. ASU 2016-09 also allows an employer to repurchase more of an employee’s shares than it previously could 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 is permitted, but all of the guidance must be adopted in the same period.

We elected to early adopt ASU 2016-09 in the second quarter of 2016, which required us to reflect any adjustments as of January 1, 2016. The primary impact of adoption was the recognition of \$0.1 million of excess tax benefits in our provision for income taxes rather than additional paid-in capital. We elected to account for forfeitures as they occur to

determine the amount of compensation cost to be recognized. The impact of this change in accounting policy was less than \$0.1 million and was recorded as a cumulative effect adjustment to retained earnings for the increase to stock compensation expense. Amendments to the accounting for minimum statutory withholding tax requirements had no impact to retained earnings as of January 1, 2016.

We elected to apply the presentation requirements for cash flows related to excess tax benefits prospectively, which resulted in an increase to net cash provided by operations and a decrease to net cash provided by financing of \$0.1 million for the three months ended March 31, 2016. The presentation requirements for cash flows related to employee taxes paid for withheld shares had no impact to our consolidated cash flow statement as such cash flows have historically been presented as a financing activity.

In August 2016, the FASB issued ASU No. 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments". This standard provides guidance on how certain cash receipts and cash payments are presented and classified in the statement of cash flows and is intended to reduce diversity in practice with respect to these items. The standard is applied using a retrospective transition method and is effective for fiscal years

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beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the potential impact of this authoritative guidance on our consolidated financial statements.

### 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 September 30, 2016 (in thousands):



|                                     | Balance<br>September<br>30,<br>2016 | Fair Value Measurements at<br>Reporting Date |          |          |
|-------------------------------------|-------------------------------------|--|----------|----------|
|                                     |                                     | Level 1                                      | Level 2  | Level 3  |
| Cash and cash equivalents           | \$ 25,337                           | \$ 25,337                                    | \$ —     | \$ —     |
| Life insurance—cash surrender value | \$ 3,737                            | \$ —   | \$ 3,737 | \$ —     |
| Contingent earn-out obligations     | \$ 2,794                            | \$ —   | \$ —     | \$ 2,794 |

Cash and cash equivalents consist primarily of highly rated money market funds at a variety of well known institutions with original maturities of three months or less. The original cost of these assets approximates fair value due to their short term maturity.

One of our operations has life insurance policies covering 52 employees with a combined face value of \$45.1 million. The policy is invested in mutual funds and the fair value measurement of the cash surrender balance associated with these policies is determined using Level 2 inputs within the fair value hierarchy and will vary with investment performance. The cash surrender value of these policies was \$3.7 million as of September 30, 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.

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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                   | (428)    |
| Adjustments to fair value     | (468)    |
| Balance at September 30, 2016 | \$ 2,794 |

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 \$55.3 million. The preliminary acquisition date fair value of consideration transferred for this acquisition was \$20.1 million, of which \$14.4 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 one acquisition in the third quarter of 2015 and 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 \$7.1 million for the nine months ended September 30, 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):

|                              | September<br>30,<br>2016 | December<br>31,<br>2015 |
|------------------------------|--------------------------|-------------------------|
| Balance at beginning of year | \$ 143,874               | \$ 140,341              |
| Additions (See Note 4)       | 4,266                    | 3,533                   |
| Balance at end of period     | \$ 148,140               | \$ 143,874              |

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## 6. Debt Obligations

Debt obligations consist of the following (in thousands):

|                                 | September<br>30,<br>2016 | December<br>31,<br>2015 |
|---------------------------------|--------------------------|-------------------------|
| Revolving credit facility       | \$ 25,000                | \$ 10,000               |
| Notes to former owners          | 2,250                    | 1,000                   |
| Other debt                      | 330                      | —                       |
| Capital lease obligations       | 313                      | 507                     |
| Total debt                      | 27,893                   | 11,507                  |
| Less—current portion            | (290)                    | (751)                   |
| Total long-term portion of debt | \$ 27,603                | \$ 10,756               |

## 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 September 30, 2016, we had \$25.0 million of outstanding borrowings, \$41.5 million in letters of credit outstanding and \$258.5 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

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| Additional Per Annum Interest Margin<br>Added Under: | Credit Facility Adjusted EBITDA |   |              |   |              |   |                 |   |
|--|---------------------------------|---|--------------|---|--------------|---|-----------------|---|
|  | Less than 0.75                  |   | 0.75 to 1.50 |   | 1.50 to 2.25 |   | 2.25 or greater |   |
| Base Rate Loan Option                                | 0.25                            | % | 0.50         | % | 0.75         | % | 0.75            | % |
| 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 1.8% as of September 30, 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 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.

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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 September 30, 2016 was 0.2.

**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 September 30, 2016 was 33.5.

**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 September 30, 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 \$2.3 million as of September 30, 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 September 30, 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 \$0.5 million as of September 30, 2016 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in October 2017.

#### Other Debt

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principle and interest due the last day of every month; ending on the December 30, 2019 maturity date. The interest rate is the one month LIBOR rate plus 2.25%. As of September 30, 2016, \$0.3 million of the note was outstanding, of which \$0.1 million was considered current.

In addition, with one of our acquisitions we acquired capital lease obligations. As of September 30, 2016, \$0.3 million of capital lease obligations were outstanding, of which \$0.2 million was considered current.

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7. Commitments and Contingencies

Claims and Lawsuits

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

Surety

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

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

Self-Insurance



We are substantially self-insured for workers' compensation, employer's liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident deductibles we absorb under our insurance arrangements for these risks. Losses 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.

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

There were approximately 0.1 million anti-dilutive stock options excluded from the calculation of diluted EPS for the three and nine months ended September 30, 2016. There were no anti-dilutive stock options for the three and nine months ended September 30, 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  |        | Nine Months   |        |
|---|---------------|--------|---------------|--------|
|   | Ended         |        | Ended         |        |
|   | September 30, |        | September 30, |        |
|   | 2016          | 2015   | 2016          | 2015   |
| Common shares outstanding, end of period  | 37,230        | 37,486 | 37,230        | 37,486 |
| Effect of using weighted average common shares outstanding                            | 130           | 66     | 150           | (55)   |
| Shares used in computing earnings per share—basic                                     | 37,360        | 37,552 | 37,380        | 37,431 |
| Effect of shares issuable under stock option plans based on the treasury stock method | 319           | 277    | 331           | 266    |
| Effect of contingently issuable restricted shares                                     | 142           | 178    | 143           | 147    |
| Shares used in computing earnings per share—diluted                                   | 37,821        | 38,007 | 37,854        | 37,844 |

## 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. On August 11, 2016, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.6 million shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of September 30, 2016, we have repurchased a cumulative total of 7.3 million shares at an average price of \$12.87 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 nine months ended September 30, 2016, we repurchased 0.4 million shares for approximately \$11.0 million at an average price of \$28.56

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 81% of our revenue is earned on a project basis for installation of mechanical systems in newly constructed facilities or for replacement of systems in existing facilities. Customers hire us to ensure such systems deliver specified or generally expected heating, cooling, conditioning and circulation of air in a facility. This entails installing core system equipment such as packaged heating and air conditioning units, or in the case of larger facilities, separate core components such as chillers, boilers, air handlers, and cooling towers. We also typically install connecting and distribution elements such as piping and ducting. Our responsibilities usually require conforming the systems to pre established engineering drawings and equipment and performance specifications, which we frequently participate in establishing. Our project management responsibilities include staging equipment and materials to project sites, deploying labor to perform the work, and coordinating with other service providers on the project, including any subcontractors we might use to deliver our portion of the work.

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

intended to cover our estimated costs on the project and provide a profit margin to us commensurate with the value of the installed system to the customer, the risk that project costs or duration will vary from estimate, the schedule on which we will be paid, the opportunities for other work that we might forego by committing capacity to this project, and other costs that we incur 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.

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.

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Labor and overhead costs account for the majority of our cost of service. Accordingly, labor management and utilization have the most impact on our project performance. Given the fixed price nature of much of our project work, if our initial estimate of project costs is wrong or we incur cost overruns that cannot be recovered in change orders, we can experience reduced profits or even significant losses on fixed price project work. We also perform some project work on a cost plus or a time and materials basis, under which we are paid our costs incurred plus an agreed upon profit margin, 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 September 30, 2016 we had 4,518 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$463,000. 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 September 30, 2016, by contract price, is as follows:

| Contract Price of Project   | No. of Projects | Aggregate Contract Price Value (millions) |
|-----------------------------|-----------------|---|
| Under \$1 million           | 4,092           | \$ 448.6                                  |
| \$1 million - \$5 million   | 336             | 763.0                                     |
| \$5 million - \$10 million  | 59              | 400.9                                     |
| \$10 million - \$15 million | 20              | 249.3                                     |
| Greater than \$15 million   | 11              | 228.1                                     |
| Total                       | 4,518           | \$ 2,089.9                                |

In addition to project work, approximately 19% of our revenue represents maintenance and repair service on already installed HVAC and controls systems. This kind of work usually takes from a few hours to a few days to perform. Prices to the customer are 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 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

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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.

## 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 nine months of 2016 continue at the improved levels we saw in 2015.



As a result of our continued strong emphasis on cash flow, at September 30, 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 the remainder of 2016 will be on execution and cost control, but we are seeking growth based on our belief that industry conditions have improved, 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.

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## 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.

## Results of Operations (dollars in thousands):

|  | Three Months Ended September 30, |         |            |         | Nine Months Ended September 30, |         |              |         |
|--|----------------------------------|---------|------------|---------|---------------------------------|---------|--------------|---------|
|  | 2016                             |         | 2015       |         | 2016                            |         | 2015         |         |
| Revenue  | \$ 428,760                       | 100.0%  | \$ 410,565 | 100.0%  | \$ 1,242,240                    | 100.0%  | \$ 1,196,679 | 100.0%  |
| Cost of services   | 335,944                          | 78.4 %  | 323,100    | 78.7 %  | 986,496                         | 79.4 %  | 962,477      | 80.4 %  |
| Gross profit   | 92,816                           | 21.6 %  | 87,465     | 21.3 %  | 255,744                         | 20.6 %  | 234,202      | 19.6 %  |
| Selling, general and administrative expenses                 | 61,032                           | 14.2 %  | 57,902     | 14.1 %  | 180,245                         | 14.5 %  | 168,967      | 14.1 %  |
| Gain on sale of assets                                       | (166)                            | —       | (298)      | (0.1) % | (523)                           | —       | (625)        | (0.1) % |
| Operating income   | 31,950                           | 7.5 %   | 29,861     | 7.3 %   | 76,022                          | 6.1 %   | 65,860       | 5.5 %   |
| Interest income  | 3                                | —       | —          | —       | 6                               | —       | 68           | —       |
| Interest expense   | (563)                            | (0.1) % | (399)      | (0.1) % | (1,870)                         | (0.2) % | (1,358)      | (0.1) % |
| Changes in the fair value of contingent earn-out obligations | 804                              | 0.2 %   | —          | —       | 468                             | —       | 125          | —       |
| Other  | 80                               | —       | 37         | —       | 455                             | —       | 64           | —       |
| Income before income taxes                                   | 32,274                           | 7.5 %   | 29,499     | 7.2 %   | 75,081                          | 6.0 %   | 64,759       | 5.4 %   |

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|   |           |       |           |       |           |       |           |       |
|---|-----------|-------|-----------|-------|-----------|-------|-----------|-------|
| Income tax expense  | 11,803    |       | 9,613     |       | 27,052    |       | 22,202    |       |
| Net income including noncontrolling interests             | 20,471    | 4.8 % | 19,886    | 4.8 % | 48,029    | 3.9 % | 42,557    | 3.6 % |
| Less: Net income attributable to noncontrolling interests | —         |       | 2,213     |       | —         |       | 6,414     |       |
| Net income attributable to Comfort Systems USA, Inc.      | \$ 20,471 |       | \$ 17,673 |       | \$ 48,029 |       | \$ 36,143 |       |

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 first quarter, and created two operating locations out of one existing operating location. As of September 30, 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 eight 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.

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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 \$18.2 million, or 4.4%, to \$428.8 million for the third quarter of 2016 compared to the same period in 2015. The increase included a 4.7% increase related to the acquisition of Shoffner partially offset by a 0.3% decrease in revenue related to same store activity. The same store revenue decrease is primarily due to our EAS operation (\$9.6 million), which experienced decreased large project work compared to the prior year, specifically in the manufacturing sector. This decrease was partially offset by an increase in activity at our Michigan operation (\$5.6 million).

Revenue increased \$45.6 million, or 3.8%, to \$1,242.2 million for the first nine months of 2016 compared to the same period in 2015. The increase included a 4.6% increase related to the acquisition of Shoffner and a 0.8% decrease in revenue related to same store activity. The same store revenue decrease is primarily due to our EAS operation (\$42.6 million), which experienced decreased large project work compared to the prior year, specifically in the manufacturing sector. This decrease was partially offset by increased activity at our Michigan operation (\$14.2 million) and our Northern Texas operation (\$11.8 million).

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

Backlog as of September 30, 2016 was \$719.3 million, a 0.7% decrease from June 30, 2016 backlog of \$724.3 million, and a 7.9% increase from September 30, 2015 backlog of \$666.3 million. Sequential backlog decreased due to completion of project work, primarily at our EAS operation (\$16.6 million), which was partially offset by an increase at our Arkansas operation (\$10.3 million). The year over year backlog increase was primarily due to the acquisition of Shoffner (\$42.8 million or 6.4%). Same store backlog increased 1.5% primarily due to increased project bookings at our New Hampshire operation (\$11.9 million).

Gross Profit—Gross profit increased \$5.4 million, or 6.1%, to \$92.8 million for the third quarter of 2016 as compared to the same period in 2015. The increase included a \$4.1 million, or 4.7%, increase related to the acquisition of Shoffner and the remainder of the increase was from same store sales. The same store increase in gross profit was primarily due to the improvement in project execution at our Colorado operation (\$1.5 million) and one of our New York operations (\$1.4 million) and increased volumes at our Wisconsin operation (\$1.3 million). This was partially offset by a decrease at our EAS operation (\$2.2 million), which 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 21.3% in 2015 to 21.6%

in 2016 primarily due to the factors discussed above.

Gross profit increased \$21.5 million, or 9.2%, to \$255.7 million for the first nine months of 2016 as compared to the same period in 2015. The increase included a \$9.3 million, or 4.0%, increase related to the acquisition of Shoffner and a \$12.2 million, or 5.2%, increase on a same store basis. The same store increase in gross profit was primarily due to broad based improvement in project execution, including our Colorado operation (\$2.7 million) and one of our New York operations (\$2.6 million). Additionally, gross profit was higher due to increased volumes at our Northern Texas operation (\$2.9 million), our Alabama operation (\$2.8 million) and our Michigan operation (\$2.7 million). This was partially offset by a decrease at our EAS operation (\$6.6 million), which has experienced a decrease in volumes when compared to the same period in 2015. As a percentage of revenue, gross profit increased from 19.6% in 2015 to 20.6% in 2016 primarily due to the factors discussed above.

Selling, General and Administrative Expenses (“SG&A”)—SG&A increased \$3.1 million, or 5.4%, to \$61.0 million for the third quarter of 2016 as compared to 2015. On a same store basis, excluding amortization expense, SG&A increased \$0.6 million, or 1.1%. This increase is primarily due to increased compensation costs (approximately \$0.3 million), which are primarily related to an increase in operating results and expanded service activities at multiple

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locations. Amortization expense decreased slightly during the period. As a percentage of revenue, SG&A increased from 14.1% in 2015 to 14.2% in 2016 primarily due to the factors discussed above.

SG&A increased \$11.3 million, or 6.7%, to \$180.2 million for the first nine months of 2016 as compared to 2015. On a same store basis, excluding amortization expense, SG&A increased \$4.4 million, or 2.7%. This increase is due to increased compensation costs (approximately \$5.0 million), which are primarily related to an increase in operating results and expanded service activities at multiple locations. This was offset by a decrease in bad debt expense (approximately \$1.3 million) primarily due to collections of aged receivables. Amortization expense decreased slightly during the period. As a percentage of revenue, SG&A increased from 14.1% in 2015 to 14.5% in 2016 primarily due to the factors discussed above.

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

|   | Three Months Ended |           | Nine Months Ended |            |
|---|--------------------|-----------|-------------------|------------|
|   | September 30,      |           | September 30,     |            |
|   | 2016               | 2015      | 2016              | 2015       |
|   | (in thousands)     |           | (in thousands)    |            |
| SG&A  | \$ 61,032          | \$ 57,902 | \$ 180,245        | \$ 168,967 |
| Less: SG&A from companies acquired              | (2,707)            | —         | (7,358)           | —          |
| Less: Amortization expense                      | (1,515)            | (1,731)   | (4,649)           | (5,163)    |
| Same-store SG&A, excluding amortization expense | \$ 56,810          | \$ 56,171 | \$ 168,238        | \$ 163,804 |

Interest Expense—Interest expense increased \$0.2 million, or 41.1%, to \$0.6 million for the third quarter of 2016 as compared to the same period in 2015. Interest expense increased \$0.5 million, or 37.7%, to \$1.9 million for the first nine months 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.

Changes in the Fair Value of Contingent Earn out Obligations—The contingent earn out obligations are measured at fair value each reporting period and changes in estimates of fair value are recognized in earnings. There was a gain of \$0.8 million from changes in the fair value of contingent earn out obligations for the third quarter of 2016. Based on updated measurements of estimated future cash flows for our contingent obligations in the third quarter of 2016, we reduced our obligation related to the EAS acquisition resulting in the current quarter gain. There were no changes in the fair value of contingent earn-out obligations for the third quarter of 2015.

Income from changes in the fair value of contingent earn out obligations for the first nine months of 2016 increased \$0.3 million as compared to the same period in 2015. Based on updated measurements of estimated future cash flows

for our contingent obligations, we reduced our obligation related to the EAS acquisition resulting in a gain of \$0.8 million. This was partially offset by increases in expense from increases in the fair value of contingent earn-out obligations related to various 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 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 nine months ended September 30, 2016 our tax expense was \$27.1 million with an effective tax rate of 36.0% as compared to tax expense of \$22.2 million with an effective tax rate of 34.3% for the same period in 2015. The effective rate for 2016 was higher than the federal statutory rate of 35.0% primarily due to state income taxes (3.6%) and non deductible expenses (0.8%) partially offset by the production activity deduction (1.8%) and a decrease in valuation allowance (0.4%). The effective rate for 2015 was lower than the federal statutory rate of 35.0% primarily due to the

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impact of the noncontrolling interest of EAS which for tax purposes was treated as a partnership (3.5%), and the production activity deduction (1.9%) partially offset by state income taxes (3.5%) and non deductible expenses (0.9%). 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 38%.

Net Income Attributable to Noncontrolling Interests—There was no net income attributable to noncontrolling interests for the first nine months 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 nine months of 2016 compared to the previous years. Our emphasis for the remainder of 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, our recent acquisition and in light of economic conditions for our industry, we expect that revenue in 2016 will be higher than in 2015. We also expect that our profitability in 2016 will exceed our 2015 profitability, and we believe that the improved activity levels will continue in 2017.

## Liquidity and Capital Resources (in thousands):

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2016                               | 2015      |
| Cash provided by (used in):                          |                                    |           |
| Operating activities                                 | \$ 49,754                          | \$ 74,583 |
| Investing activities                                 | (74,920)                           | (20,483)  |
| Financing activities                                 | (5,961)                            | (41,092)  |
| Net increase (decrease) in cash and cash equivalents | \$ (31,127)                        | \$ 13,008 |
| Free cash flow:                                      |                                    |           |
| Cash provided by operating activities                | \$ 49,754                          | \$ 74,583 |
| Purchases of property and equipment                  | (17,257)                           | (15,216)  |
| Proceeds from sales of property and equipment        | 847                                | 891       |
| Free cash flow                                       | \$ 33,344                          | \$ 60,258 |

## Cash Flow



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

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

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Cash provided by operating activities was \$49.8 million during the first nine months of 2016 compared with \$74.6 million during the same period in 2015. The \$24.8 million decrease is primarily due to decreases in billings in excess of costs of \$13.8 million, primarily due to the timing of billings and various project work, and accounts payable and accrued liabilities which had an impact of \$18.4 million. The decreases in cash provided by accounts payable and accrued liabilities was primarily due to a large benefit in the prior year that did not repeat related to the timing of payments and compensation accruals. These uses of operating cash flow were partially offset by the change in costs and estimated earnings in excess of billings of \$4.9 million primarily related to project work timing and overall higher net income in the first nine months of 2016 compared to the same period in 2015.

**Cash Used in Investing Activities**—During the first nine months of 2016, cash used in investing activities was \$74.9 million compared to \$20.5 million during the same period in 2015. The \$54.4 million increase in cash used primarily relates to cash paid for the EAS and Shoffner acquisitions in 2016 (\$56.3 million).

**Cash Used in Financing Activities**—Cash used in financing activities was \$6.0 million for the first nine months of 2016 compared to \$41.1 million during the same period in 2015. The \$35.1 million decrease in cash used in financing activities is primarily due to net borrowings on the revolving credit facility during the first nine months of 2016 of \$15.0 million compared to net payments during the same period in 2015 of \$28.5 million. Additionally, we repurchased \$6.0 million of incremental shares in the first nine months of 2016.

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

## Share Repurchase Program

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time approved extensions of the program to acquire additional shares. On August 11, 2016, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.6 million shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of September 30, 2016, we have repurchased a cumulative total of 7.3 million shares at an average price of \$12.87 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 nine months ended September 30, 2016, we repurchased 0.4 million shares for approximately \$11.0 million at an average price of \$28.56 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 September 30, 2016, we had \$25.0 million of outstanding borrowings, \$41.5 million in letters of credit outstanding and \$258.5 million of credit available.

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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 September 30, 2016 was 0.2.

**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 September 30, 2016 was 33.5.

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 September 30, 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 \$2.3 million as of September 30, 2016. In conjunction with the Shoffner acquisition in the first quarter, we issued a subordinated note to former owners with an outstanding balance

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of \$1.8 million as of September 30, 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 \$0.5 million as of September 30, 2016 that bears interest, payable quarterly, at a weighted average interest rate of 2.5%. The principal is due in October 2017.

## Other Debt

As part of the Shoffner acquisition, we acquired debt with an outstanding balance at the acquisition date of \$0.4 million with principle and interest due the last day of every month; ending on the December 30, 2019 maturity date. The interest rate is the one month LIBOR rate plus 2.25%. As of September 30, 2016, \$0.3 million of the note was outstanding, of which \$0.1 million was considered current.

In addition, with one of our acquisitions we acquired capital lease obligations. As of September 30, 2016, \$0.3 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 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

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incur. To date, we are not aware of any losses to our sureties in connection with bonds the sureties have posted on our behalf, and we do not expect such losses to be incurred in the foreseeable future.

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

## Contractual Obligations

As of September 30, 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 1.8% as of September 30, 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.

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Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the three months ended September 30, 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. On August 11, 2016, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.6 million shares. Since the inception of the repurchase program, the Board has approved 8.1 million shares to be repurchased. As of September 30, 2016, we have repurchased a cumulative total of 7.3 million shares at an average price of \$12.87 per share under the repurchase program.

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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 nine months ended September 30, 2016, we repurchased 0.4 million shares for approximately \$11.0 million at an average price of \$28.56 per share.

During the quarter ended September 30, 2016, we purchased our common shares in the following amounts at the following average prices:

| Period                     | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------------------|----------------------------------|------------------------------|--|--|
| July 1 - July 31           | 3,000                            | \$ 30.92                     | 7,055,629  | 505,554  |
| August 1 - August 31       | 133,364                          | \$ 29.03                     | 7,188,993  | 923,500  |
| September 1 - September 30 | 77,614                           | \$ 26.92                     | 7,266,607  | 845,886  |
|                            | 213,978                          | \$ 28.29                     | 7,266,607  | 845,886  |

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 performance restricted stock awards and the 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

|                   |  | Incorporated by Reference<br>to the Exhibit Indicated Below<br>and to the Filing with the<br>Commission Indicated Below |                            |
|-------------------|--|---|----------------------------|
| Exhibit<br>Number | Description of Exhibits  | Exhibit<br>Number   | Filing or<br>File Number   |
| 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               | Certificate of Amendment dated May 20, 2016  | 3.1   | May 20, 2016               |
| 3.5               | Amended and Restated Bylaws of Comfort Systems USA, Inc.   | 3.1   | Form 8 K<br>March 25, 2016 |
| 31.1              | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002 |   | Form 8 K<br>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  |   |                            |

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SIGNATURES

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

Comfort Systems USA, Inc.

October 27, 2016 By: /s/ Brian E. Lane  
Brian E. Lane  
President, Chief Executive Officer and Director

October 27, 2016 By: /s/ William George  
William George  
Executive Vice President and Chief Financial Officer

October 27, 2016 By: /s/ Julie S. Shaeff  
Julie S. Shaeff  
Senior Vice President and Chief Accounting Officer