

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, 1998

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 (I.R.S. EMPLOYER  
OF INCORPORATION OR ORGANIZATION) IDENTIFICATION NO.)

777 POST OAK BOULEVARD  
SUITE 500  
HOUSTON, TEXAS 77056  
(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

The number of shares outstanding of the issuer's common stock, as of  
November 16, 1998, was 37,088,733.

COMFORT SYSTEMS USA, INC.  
INDEX TO FORM 10-Q  
FOR THE QUARTER ENDED SEPTEMBER 30, 1998

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COMFORT SYSTEMS USA, INC.  
PART I, ITEM 1 -- FINANCIAL INFORMATION  
GENERAL INFORMATION

INTRODUCTION TO PRO FORMA COMBINED STATEMENTS OF OPERATIONS

Comfort Systems USA, Inc. ("Comfort Systems" and collectively with its subsidiaries, the "Company") was founded in December 1996 to become a leading national provider of heating, ventilation and air conditioning ("HVAC") services, focusing primarily on the commercial and industrial markets.

On July 2, 1997, the Company completed the initial public offering (the "IPO") of its common stock (the "Common Stock") and simultaneously acquired 12 companies (collectively referred to as the "Founding Companies") engaged principally in the commercial and industrial HVAC business. The closing of the acquisitions of the Founding Companies and the IPO occurred on July 2, 1997. The acquisitions of the Founding Companies have been accounted for using the purchase method of accounting.

Subsequent to July 2, 1997, and through September 30, 1998, the Company acquired 70 additional HVAC and complementary businesses (collectively with the Founding Companies referred to as the "Acquired Companies"). Of these additional businesses acquired, 17 acquisitions were accounted for as poolings-of-interests (the "Pooled Companies"). The remaining businesses acquired were accounted for as purchases (the "Purchased Companies").

On June 16, 1998, the Company completed a second public offering (the "Second Public Offering") of 400,000 shares of its Common Stock. The net proceeds from this offering of \$7.6 million were used to repay debt.

The following unaudited pro forma combined statements of operations assume that the IPO and the acquisitions of the Founding Companies were consummated on January 1, 1997. This pro forma presentation also gives effect to the retroactive restatement to January 1, 1997, of 16 of the 17 Pooled Companies and reflects the acquisitions of the Purchased Companies acquired subsequent to the IPO through September 30, 1998, from the date of their respective acquisitions. This presentation is not intended to be in accordance with the regulations promulgated by the Securities and Exchange Commission.

The Acquired Companies were managed prior to their acquisitions as independent private companies. Therefore, historical selling, general and administrative expenses for the periods presented in the condensed consolidated statements of operations reflect compensation and related benefits those owners received from their respective businesses prior to acquisition. Historical selling, general and administrative expenses also include the non-recurring, non-cash compensation charge of \$11.6 million recorded by Comfort Systems in the first quarter of 1997 related to Common Stock issued to management of and consultants to the Company (the "Compensation Charge") prior to the IPO. The pro forma combined adjustments reflect (a) a decrease in selling, general and administrative expenses to exclude the Compensation Charge for the first quarter of 1997, (b) certain reductions in salaries and benefits to the former owners of the Acquired Companies which they agreed would take effect as of the date of acquisition (the "Compensation Differential"), (c) pro forma combined compensation expense of \$430,000 for the nine months ended September 30, 1997, to reflect the ongoing salaries received by corporate management of the Company as though those salaries were paid prior to the IPO, (d) amortization of goodwill related to the Founding Companies, and (e) pro forma interest expense on borrowings that would have been necessary to fund certain S Corporation Distributions related to the Founding Companies, as if those distributions had been made on January 1, 1997. In addition, an incremental tax provision has been recorded as if all applicable Purchased and Founding Companies, and Pooled Companies, which were C Corporations, had been subject to federal and state income taxes.

Historical and pro forma interim periods results are not necessarily indicative of future results because, among other things, the Acquired Companies were not under common control or management prior to their acquisition. The Company's results of operations historically have been subject to seasonal fluctuations. These pro forma combined statements of operations should be read

in conjunction with the additional information and the respective financial statements and related notes of Comfort Systems and the Founding Companies included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission.

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COMFORT SYSTEMS USA, INC.  
 PRO FORMA COMBINED STATEMENTS OF OPERATIONS  
 (IN THOUSANDS, EXCEPT PER SHARE DATA)  
 (UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998
REVENUES .....	\$ 262,116	\$ 559,339
COST OF SERVICES .....	191,066	423,223
Gross profit .....	71,050	136,116
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES .....	44,466	85,845
GOODWILL AMORTIZATION .....	2,623	4,642
Operating income .....	23,961	45,629
OTHER INCOME (EXPENSE):		
Interest expense, net .....	(669)	(3,731)
Other income, net .....	128	156
Other income (expense) .....	(541)	(3,575)
INCOME BEFORE INCOME TAXES .....	23,420	42,054
PROVISION FOR INCOME TAXES .....	9,390	18,394
PRO FORMA COMBINED NET INCOME .....	\$ 14,030	\$ 23,660
PRO FORMA COMBINED NET INCOME PER SHARE:		
Basic .....	\$ .56	\$ .75
Diluted .....	\$ .55	\$ .74
SHARES USED IN COMPUTING PRO FORMA COMBINED NET INCOME PER SHARE:		
Basic .....	25,080	31,689
Diluted .....	25,297	32,179

This pro forma combined financial information may not be comparable to and may not be indicative of the Company's future results of operations because the Acquired Companies were not under common control or management prior to their acquisition.

The accompanying note is an integral part of these pro forma combined statements of operations.

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COMFORT SYSTEMS USA, INC.  
 NOTE TO PRO FORMA COMBINED STATEMENTS OF OPERATIONS

The computation of the weighted average shares outstanding for pro forma combined net income per share for the nine months ended September 30, 1997 and 1998, is calculated as follows (in thousands):

NINE MONTHS ENDED  
SEPTEMBER 30,

	1997	1998
	-----	-----
Shares issued in connection with the acquisitions of the Founding Companies .....	9,721	9,721
Shares sold pursuant to the IPO .....	6,100	6,100
Shares held by Notre Capital Ventures II, L.L.C. ("Notre"), Comfort Systems' management and consultants .....	4,240	4,240
Shares issued in connection with the acquisitions of the Pooled Companies .....	5,946	5,946
Shares sold in connection with the underwriter's overallotment for the IPO and Second Public Offering .....	272	1,037
Weighted average portion of shares issued in connection with the acquisition of the Purchased Companies .....	4	4,482
Weighted average portion of shares sold in the Second Public Offering .....	--	152
Weighted average portion of shares issued in connection with the Employee Stock Purchase Plan .....	--	6
Weighted average portion of shares issued in connection with the exercise of stock options .....	--	5
Less: Shares sold in the IPO that were not used for the cash portion of the acquisition of the Founding Companies .....	1,203	
	-----	-----
Weighted average shares outstanding - Basic .....	25,080	31,689
Weighted average portion of shares related to stock options under the treasury stock method .....	217	490
	-----	-----
Weighted average shares outstanding - Diluted .....	25,297	32,179
	=====	=====

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COMFORT SYSTEMS USA, INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS, EXCEPT SHARE INFORMATION)  
(UNAUDITED)

	DECEMBER 31, 1997	SEPTEMBER 30, 1998
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents .....	\$ 18,097	\$ 9,687
Accounts receivable, less allowance of \$1,698 and \$3,526 .....	84,422	191,079
Other receivables .....	884	2,360
Inventories .....	7,360	13,209
Prepaid expenses and other .....	4,749	10,602
Costs and estimated earnings in excess of billings .....	14,034	26,595
Total current assets .....	129,546	253,532
PROPERTY AND EQUIPMENT, net .....	13,649	26,054
GOODWILL, less accumulated amortization of \$1,851 and \$6,493 .....	163,126	310,452
OTHER NONCURRENT ASSETS .....	2,226	10,611
	-----	-----
Total assets .....	\$308,547	\$600,649
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt .....	\$ 2,329	\$ 6,821
Accounts payable .....	28,354	56,728
Accrued compensation and benefits .....	7,522	21,280
Billings in excess of costs and estimated earnings .....	11,525	31,220
Income taxes payable .....	4,889	3,259
Other current liabilities .....	11,676	16,856
	-----	-----
Total current liabilities .....	66,295	136,164
DEFERRED INCOME TAXES .....	1,061	889
LONG-TERM DEBT, NET OF CURRENT MATURITIES .....	21,934	127,969
OTHER LONG-TERM LIABILITIES .....	1,501	1,309
	-----	-----

Total liabilities ..... 90,791 266,331

COMMITMENTS AND CONTINGENCIES

STOCKHOLDERS' EQUITY:

Preferred Stock, \$.01 par, 5,000,000 shares authorized, none issued and outstanding .....	--	--
Common stock, \$.01 par, 102,969,912 shares authorized, 28,013,436 and 34,922,169 shares issued and outstanding, respectively .....	280	349
Additional paid-in capital .....	205,827	300,644
Retained earnings .....	11,649	33,325
	-----	-----
Total stockholders' equity .....	217,756	334,318
	-----	-----
Total liabilities and stockholders' equity .....	\$308,547	\$600,649
	=====	=====

Reflects a 121.1387-for-one stock split effective on March 19, 1997

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

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COMFORT SYSTEMS USA, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
(IN THOUSANDS, EXCEPT PER SHARE DATA)  
(UNAUDITED)

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998	1997	1998
REVENUES .....	\$ 97,454	\$ 232,381	\$ 175,411	\$ 559,339
COST OF SERVICES .....	70,249	175,308	128,481	423,223
	-----	-----	-----	-----
Gross profit .....	27,205	57,073	46,930	136,116
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES .....	17,832	34,405	46,758	87,609
GOODWILL AMORTIZATION .....	883	1,854	883	4,642
	-----	-----	-----	-----
Operating income (expense) .....	8,490	20,814	(711)	43,865
OTHER INCOME (EXPENSE):				
Interest income .....	586	233	778	625
Interest (expense) .....	(561)	(1,941)	(825)	(4,356)
Other .....	24	137	18	156
	-----	-----	-----	-----
Other income (expense) .....	49	(1,571)	(29)	(3,575)
	-----	-----	-----	-----
INCOME (LOSS) BEFORE INCOME TAXES .....	8,539	19,243	(740)	40,290
PROVISION FOR INCOME TAXES .....	4,899	8,444	4,575	17,687
	-----	-----	-----	-----
NET INCOME (LOSS) .....	\$ 3,640	\$ 10,799	\$ (5,315)	\$ 22,603
	=====	=====	=====	=====
NET INCOME (LOSS) PER SHARE:				
Basic .....	\$ .14	\$ .32	\$ (.33)	\$ .71
	=====	=====	=====	=====
Diluted .....	\$ .13	\$ .31	\$ (.33)	\$ .70
	=====	=====	=====	=====
SHARES USED IN COMPUTING NET INCOME (LOSS) PER SHARE:				
Basic .....	26,834	33,964	16,013	31,689
	=====	=====	=====	=====
Diluted .....	27,485	34,454	16,230	32,179
	=====	=====	=====	=====

Reflects a 121.1387-for-one stock split effective on March 19,1997

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

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COMFORT SYSTEMS USA, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)  
(UNAUDITED)

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS (DEFICIT)	TOTAL STOCKHOLDERS' EQUITY
	SHARES	AMOUNT			
BALANCE AT DECEMBER 31, 1996 .....	5,859,881	\$ 58	\$ 188	\$ 14,843	\$ 15,089

Issuance of Common Stock:					
Initial Public Offering .....	7,015,000	70	79,805	--	79,875
Acquisition of Founding Companies .....	9,720,927	98	100,999	--	101,097
Issuance of management shares .....	4,118,708	41	11,556	--	11,597
Acquisition of Purchased Companies .....	1,092,489	11	13,253	--	13,264
S Corporation distributions made by certain					
Pooled Companies .....	--	--	--	(2,173)	(2,173)
Pooling not restated .....	206,431	2	26	853	881
Net loss .....	--	--	--	(1,874)	(1,874)
	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 1997 .....	28,013,436	280	205,827	11,649	217,756
Issuance of Common Stock:					
Second Public Offering .....	861,479	9	15,892	--	15,901
Acquisition of Purchased Companies .....	6,000,485	60	78,225	--	78,285
Employee Stock Purchase Plan shares .....	29,362	--	482	--	482
Exercise of Options .....	17,407	--	218	--	218
S Corporation distributions made by certain					
Pooled Companies .....	--	--	--	(927)	(927)
Net income .....	--	--	--	22,603	22,603
	-----	-----	-----	-----	-----
BALANCE AT SEPTEMBER 30, 1998 .....	34,922,169	\$ 349	\$ 300,644	\$ 33,325	\$ 334,318
	=====	=====	=====	=====	=====

Reflects a 121.1387-for-one stock split effective on March 19, 1997

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

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COMFORT SYSTEMS USA, INC.  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)  
(UNAUDITED)

	NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998
	-----	-----
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss) .....	\$ (5,315)	\$ 22,603
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities --		
Depreciation and amortization expense .....	2,867	9,219
Bad debt expense .....	302	384
Compensation expense related to issuance of management shares .	11,556	--
Deferred tax expense (benefit) .....	(2,700)	(118)
Loss (gain) on sale of property and equipment .....	9	(158)
Current taxes on acquired S corporations .....	610	--
Changes in operating assets and liabilities, net of effects of acquisitions of Founding and Purchased Companies--		
(Increase) decrease in --		
Receivables, net .....	(7,859)	(39,302)
Inventories .....	264	(1,420)
Prepaid expenses and other current assets .....	1,724	(6,744)
Cost and estimated earnings in excess of billings .....	(3,340)	(4,241)
Other noncurrent assets .....	167	499
Increase (decrease) in --		
Accounts payable and accrued liabilities .....	5,281	(3,642)
Billings in excess of costs and estimated earnings .....	936	4,299
Other, net .....	(73)	(1,262)
	-----	-----
Net cash provided by (used in) operating activities .....	4,429	(19,883)
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment .....	(3,011)	(7,069)
Proceeds from sales of property and equipment .....	235	699
Cash paid for Purchased Companies, net of cash acquired .....	(43,037)	(62,683)
	-----	-----
Net cash used in investing activities .....	(45,813)	(69,053)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Payments on long-term debt .....	(49,097)	(63,185)
Borrowings of long-term debt .....	50,845	127,928
S Corporation Distributions paid by certain Pooled Companies ..	(1,603)	(821)
Proceeds from issuance of Common Stock .....	79,916	16,604
	-----	-----
Net cash provided by financing activities .....	\$ 80,061	\$ 80,526
	-----	-----

NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS .....	\$ 38,677	\$ (8,410)
CASH AND CASH EQUIVALENTS, beginning of period .....	7,003	18,097
	-----	-----
CASH AND CASH EQUIVALENTS, end of period .....	\$ 45,680	\$ 9,687
	=====	=====

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

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COMFORT SYSTEMS USA, INC.  
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 1998  
(UNAUDITED)

1. BUSINESS AND ORGANIZATION:

The Company is a national provider of comprehensive HVAC installation and maintenance, repair and replacement services. Founded in December 1996, the Company is consolidating the fragmented commercial and industrial HVAC markets, and performs most of its services within manufacturing plants, office buildings, retail centers, apartment complexes, and healthcare, education and government facilities. In addition to standard HVAC services, the Company also provides specialized applications such as process cooling, control systems, electronic monitoring and process piping. Certain locations also perform related services such as electrical and plumbing.

On July 2, 1997, Comfort Systems completed the IPO and simultaneously acquired the 12 Founding Companies. Subsequent to the IPO and through September 30, 1998, the Company has acquired 70 HVAC and complementary businesses.

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 included in the Company's Annual Report on Form 10-K for the year ended December 31, 1997.

There were no significant changes in the accounting policies of the Company during the periods presented. For a description of the significant accounting policies of the Company, refer to Note 2 of Notes to Consolidated Financial Statements of Comfort Systems included in the Company's Annual Report on Form 10-K for the year ended December 31, 1997.

The regulations for unaudited interim financial statements such as those in this report allow certain information and footnotes required by generally accepted accounting principles for year end financial statements to be excluded.

The Company believes all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature.

The results of operations for interim periods are not necessarily indicative of the results for the fiscal year.

CASH FLOW INFORMATION

Cash paid for interest for the nine months ended September 30, 1997 and 1998 was approximately \$0.9 million and \$3.7 million, respectively. Cash paid for income taxes for the nine months ended September 30, 1997 and 1998 was approximately \$0.4 million and \$24.1 million, respectively.

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3. BUSINESS COMBINATIONS:

POOLINGS

During the second half of 1997, the Company acquired all of the outstanding stock of 14 Pooled Companies in exchange for 4,507,406 shares of Common Stock. These acquisitions have been accounted for as poolings-of-interests as described in Note 2 of Notes to Consolidated Financial Statements of Comfort Systems

included in the Company's Annual Report on Form 10-K for the year ended December 31, 1997. These companies provide HVAC and complementary services.

During the third quarter of 1998, the Company acquired all of the outstanding stock of three Pooled Companies in exchange for 1,437,767 shares of Common Stock. These acquisitions have been accounted for as poolings-of-interests. Two of the three Pooled Companies have been retroactively restated to January 1, 1997. These companies provide HVAC and complementary services. The combined revenue and income before income taxes of the two restated Pooled Companies for the period prior to their acquisition by the Company was as follows (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998	1997	1998
Revenues .....	\$14,492	\$18,273	\$36,991	\$50,657
Income before taxes .....	684	1,601	769	1,742

#### PURCHASES

Simultaneous with the IPO, Comfort Systems acquired the 12 Founding Companies for \$45.3 million in cash and 9,720,927 shares of Common Stock. The Founding Companies provide HVAC and complementary services.

Subsequent to the IPO and through December 31, 1997, Comfort Systems acquired 13 of the Purchased Companies. These companies provide HVAC and complementary services. The aggregate consideration paid in these transactions was \$14.5 million in cash, 1,092,489 shares of Common Stock valued at \$13.3 million and \$5.0 million in the form of convertible subordinated notes (the "Notes"). These Notes are convertible at various dates in the fourth quarter of 1998 or 1999 and thereafter into 225,473 or 220,449 shares of Common Stock, respectively.

For the three months ended March 31, 1998, Comfort Systems acquired 11 additional companies, which were accounted for as purchase transactions. These companies also provide HVAC and complementary services. The aggregate consideration in these transactions was \$16.6 million in cash, 2,220,416 shares of Common Stock valued at \$25.8 million, and \$1.9 million in Notes. Approximately \$1.3 million of these Notes are convertible at various dates in 2000, 2001 and 2002 into 53,700 shares of Common Stock, respectively. The allocation of the respective purchase prices to the assets assumed and liabilities acquired resulted in \$43.7 million of goodwill related to the companies acquired during the first three months of 1998.

For the three months ended June 30, 1998, Comfort Systems acquired 17 additional companies, which were accounted for as purchase transactions. These companies also provide HVAC and complementary services. The aggregate consideration in these transactions was \$36.8 million in cash, 2,016,141 shares of Common Stock valued at \$29.1 million, and \$17.7 million in Notes. Approximately all of these Notes are convertible at various dates in 1999, 2000 and 2001 into 603,430 shares of Common Stock. The allocation of the respective purchase prices to the assets assumed and liabilities acquired resulted in \$69.0 million of goodwill related to the companies acquired during the second quarter of 1998.

For the three months ended September 30, 1998, Comfort Systems acquired 12 additional companies, which were accounted for as purchase transactions. These companies also provide HVAC and complementary services. The aggregate consideration in these transactions was \$22.6 million in cash, 1,763,928 shares of Common Stock valued at \$23.5 million, and \$3.9 million in Notes. The Notes are convertible beginning in 1999 into 149,533 shares of Common Stock. The allocation of the respective purchase prices to the assets assumed and liabilities acquired resulted in \$41.8 million of goodwill related to the companies acquired during the third quarter of 1998.

The accompanying balance sheets include allocations of the respective purchase prices to the assets acquired and liabilities assumed based on preliminary estimates of fair value and is subject to final adjustment.

The unaudited pro forma data presented below consists of the income statement data presented in these consolidated financial statements plus income statement data for the Founding Companies and Purchased Companies as if those companies



had been acquired on January 1, 1997 through the respective dates of acquisitions (in thousands, except per share data):

	NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998
	(UNAUDITED)	
Revenues .....	\$595,582	\$682,249
Net income .....	\$ 23,522	\$ 22,329
Net income per share - Diluted .....	\$ .73	\$ .64
Shares used in computing net income - Diluted .....	32,385	34,802

Pro forma adjustments included in the preceding tables regarding the Acquired Companies primarily relate to (a) the Compensation Differential relating to the former owners of the Acquired Companies which they agreed would take effect as of the acquisition date, (b) pro forma compensation expense of \$430,000 for the nine months ended September 30, 1997, to reflect the ongoing salaries received by corporate management as though those salaries were being paid prior to the IPO, (c) amortization of goodwill related to the Purchased and Founding Companies, (d) elimination of the non-recurring, non-cash Compensation Charge of \$11.6 million recorded by Comfort Systems in the first quarter of 1997 related to Common Stock issued to management of and consultants to the Company, (e) interest expense on borrowings of \$22.8 million that would have been necessary to fund certain S Corporation Distributions of the Acquired Companies as if those distributions had occurred on January 1, 1997, (f) interest expense on borrowings of \$75.9 million related to the purchase price of the Purchased Companies acquired during the three quarters of 1998, and (g) interest expense related to the subordinated convertible notes issued in connection with the acquisition of certain Acquired Companies. In addition, an incremental tax provision has been recorded as if all applicable Purchased and Founding Companies, and Pooled Companies, which were C Corporations, had been subject to federal and state corporate income taxes for the applicable periods presented.

The pro forma combined results presented above are not necessarily indicative of actual results which might have occurred had the operations and management teams of the Company and the Acquired Companies been combined at the beginning of the periods presented.

ADDITIONAL ACQUISITIONS

Subsequent to September 30, 1998, and through November 16, 1998, the Company completed 7 additional acquisitions (the "Additional Acquisitions") for approximately \$83.8 million in cash, 2,646,508 shares of Common Stock and \$33.4 million in Notes. Annualized revenues from the businesses acquired in the Additional Acquisitions were approximately \$249 million. All of these acquisitions will be accounted for as purchase transactions.

4. LONG-TERM DEBT OBLIGATIONS:

Long-term debt obligations consist of the following (in thousands):

	DECEMBER 31, 1997	SEPTEMBER 30, 1998
Revolving credit facility.....	\$ 15,300	\$ 103,850
Notes.....	4,978	28,539
Other.....	3,985	2,401
Total debt.....	24,263	134,790
Less: current maturities.....	2,329	6,821
	\$ 21,934	\$ 127,969
	=====	=====

In July 1997, the Company entered into a credit agreement with Bank One, Texas, N.A. (the "Credit Facility"). The Credit Facility was amended and restated in September 1997 primarily to provide for additional banks to lend to the Company under the Credit Facility. The Credit Facility was further amended in April 1998 in order to increase borrowing capacity and to provide for additional banks to lend to the Company under the Credit Facility. The Credit Facility provides the Company with an unsecured revolving line of credit of \$175

million. The Company has a choice of two interest rate options when borrowing under the Credit Facility. Under one option, the interest rate is determined based on the higher of the Federal Funds Rate plus one-half percentage point or the bank's prime rate. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate the London Interbank Offered Rates or LIBOR, as published in major financial media) plus 0.75 to 1.5 percentage points. The amount of percentage points added depends on the ratio of the Company's debt to earnings before interest, taxes, depreciation and amortization for the preceding twelve months ("EBITDA"). For purposes of this ratio, EBITDA may include the preceding twelve months' results for any companies acquired during the last year. In addition, commitment fees of 0.125% to 0.375% per annum, also depending on the ratio of debt to EBITDA, are payable on the unused portion of the facility. The Credit Facility prohibits the payment of dividends by the Company without lender's approval and requires the Company to comply with certain financial covenants. The Credit Facility expires on April 14, 2001, at which time all amounts outstanding under the facility are due.

As of September 30, 1998, the Company had borrowed \$103.9 million under the Credit Facility at an average interest rate of approximately 6.5% per annum for the first nine months of 1998. As of November 10, 1998, \$105.8 million was outstanding under this facility.

As of September 30, 1998, Notes in the amount of \$28.5 million referred to above were issued to former owners of certain Purchased Companies as partial consideration for the acquisition of their companies. Of these Notes, \$27.9 million bear interest, payable quarterly, at a weighted average interest rate of 5.9% and are convertible by the holder into shares of the Company's Common Stock at a weighted average price of \$27.38 per share. The terms of these Notes require \$6.3 million of principal payments in 1999, \$10.7 million of principal payments in 2000, \$10.0 million of principal payments in 2001 and \$0.4 million of principal payments in 2002 and 2003. The remaining Notes of \$0.6 million are non-interest bearing, with \$0.2 million of principal payments due in 1999, followed by four equal annual installments beginning in 2000.

As of September 30, 1998, other long-term debt of \$2.4 million referred to above includes secured debt, unsecured debt and capitalized lease obligations of the Company.

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## 5. COMMITMENTS AND CONTINGENCIES:

### CLAIMS AND LAWSUITS

The Company is from time to time party to litigation in the ordinary course of business. There are currently no pending legal proceedings that, in management's opinion, would have a material adverse effect on the Company's operating results or financial condition. The Company maintains various insurance coverages in order to minimize financial risk associated with certain claims. The Company has provided accruals for probable losses and legal fees associated with certain of these actions in the accompanying consolidated financial statements.

## 6. STOCKHOLDERS' EQUITY:

### COMMON STOCK AND PREFERRED STOCK

Comfort Systems effected a 121.1387-for-one stock split on March 19, 1997 for each share of Common Stock of the Company then outstanding. In addition, the Company increased the number of authorized shares of Common Stock to 102,969,912 and authorized 5,000,000 shares of \$.01 par value preferred stock. The effects of the Common Stock split and the increase in the number of shares of authorized Common Stock have been retroactively reflected on the balance sheet and in the accompanying notes as applicable.

In connection with the organization and initial capitalization of Comfort Systems, the Company issued 121,139 shares of Common Stock at \$.01 per share to Notre. In January 1997, the Company issued 2,848,773 additional shares to Notre for \$.01 per share.

In January and February 1997, the Company issued a total of 1,269,935 shares of Common Stock to management of and consultants to the Company at a price of \$.01 per share. As a result, the Company recorded a non-recurring, non-cash compensation charge of \$11.6 million in the first quarter of 1997, representing

the difference between the amount paid for the shares and the estimated fair value of the shares on the date of sale.

#### RESTRICTED COMMON STOCK

In March 1997, Notre exchanged 2,742,912 of its shares of Common Stock for an equal number of shares of restricted voting common stock ("Restricted Voting Common Stock"). The holder of Restricted Voting Common Stock is entitled to elect one member of the Company's Board of Directors and to 0.55 of one vote for each share on all other matters on which they are entitled to vote. Holders of Restricted Voting Common Stock are not entitled to vote on the election of any other directors.

Each share of Restricted Voting Common Stock will automatically convert to Common Stock on a share-for-share basis (i) in the event of a disposition of such share of Restricted Voting Common Stock by the holder thereof (other than a distribution which is a distribution by a holder to its partners or beneficial owners, or a transfer to a related party of such holders (as defined in Sections 267, 707, 318 and/or 4946 of the Internal Revenue Code of 1986, as amended)), (ii) in the event any person acquires beneficial ownership of 15% or more of the total number of outstanding shares of Common Stock of the Company, or (iii) in the event any person offers to acquire 15% or more of the total number of outstanding shares of Common Stock of the Company. After July 1, 1998, the Board of Directors may elect to convert any remaining shares of Restricted Voting Common Stock into shares of Common Stock in the event 80% or more of the originally outstanding shares of Restricted Voting Common Stock have been previously converted into shares of Common Stock.

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#### EARNINGS PER SHARE

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards ("SFAS") No. 128, "Earnings Per Share." SFAS No. 128 revises the methodology to be used in computing earnings per share (EPS) such that the computations previously required for primary and fully diluted EPS are to be replaced with "basic" and "diluted" EPS. Basic 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 in the same manner as fully diluted EPS, except that, among other changes, the average share price for the period is used in all cases when applying the treasury stock method to potentially dilutive outstanding options. The Company has adopted SFAS No. 128 and restated EPS for all periods presented.

The following table summarizes weighted average shares outstanding for each of the periods presented (in thousands):

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1997	1998	1997	1998
Shares issued in connection with the acquisitions of the Founding Companies	9,721	9,721	3,431	9,721
Shares sold pursuant to the IPO	6,100	6,100	2,120	6,100
Shares held by Notre, Comfort Systems' management and consultants	4,240	4,240	4,240	4,240
Shares issued in connection with the acquisitions of Pooled Companies	5,946	5,946	5,946	5,946
Shares sold in connection with the underwriter's over-allotment for the IPO and Second Public Offering	814	1,276	272	1,037
Weighted average portion of shares issued in connection with the acquisition of the Purchased Companies	13	6,245	4	4,482
Weighted average portion of shares sold in the Second Public Offering	--	400	--	152
Weighted average portion of shares issued in connection with the Employee Stock Purchase Plan	--	20	--	6
Weighted average portion of shares issued in connection with the exercise of stock options	--	16	--	5
Weighted average shares outstanding - Basic	26,834	33,964	16,013	31,689
Weighted average portion of shares related to stock options under the treasury stock method	651	490	217	490
Weighted average shares outstanding - Diluted	27,485	34,454	16,230	32,179

#### 7. SUBSEQUENT EVENTS:

Subsequent to September 30, 1998, and through November 16, 1998, the Company completed 7 additional acquisitions (the "Additional Acquisitions") for

approximately \$83.8 million in cash, 2,646,508 shares of Common Stock and \$33.4 million in Notes. Annualized revenues from the businesses acquired in the Additional Acquisitions were approximately \$249 million. All of these acquisitions will be accounted for as purchase transactions.

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COMFORT SYSTEMS USA, INC.

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

INTRODUCTION

The following discussion should be read in conjunction with the consolidated historical and pro forma combined financial statements of the Company and related notes thereto included elsewhere in this Form 10-Q and the Annual Report on Form 10-K for the year ended December 31, 1997 (the "Form 10-K"). This discussion contains forward-looking statements regarding the business and industry of the Company within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on the current plans and expectations of the Company and involve risks and uncertainties that could cause 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 "Factors Which May Affect Future Results," included in the Form 10-K.

The Company is a leading national provider of comprehensive HVAC installation, as well as maintenance, repair and replacement services. Founded in December 1996, the Company is consolidating the fragmented commercial and industrial HVAC markets and performs most of its services within manufacturing plants, office buildings, retail centers, apartment complexes, and healthcare, education and government facilities. In addition to standard HVAC services, the Company also provides specialized applications such as process cooling, control systems, electronic monitoring and process piping. Certain locations also perform related services such as electrical and plumbing.

On July 2, 1997, the Company completed its IPO and simultaneously acquired the 12 Founding Companies. Subsequent to the IPO, and through December 31, 1997, the Company acquired 27 additional HVAC and complementary businesses. Of these additional acquisitions, 14 were accounted for as poolings-of-interests and the remaining 13 acquisitions were accounted for as purchases. The historical financial statements of the Company have not been retroactively restated to give effect to the operations of one of the Pooled Companies which is considered immaterial. Subsequent to December 31, 1997 and through September 30, 1998, the Company acquired 40 additional HVAC businesses which have been accounted for as purchases. Additionally, during the third quarter of 1998, the Company completed three acquisitions which were accounted for as poolings-of-interests.

Pro forma combined and historical results are not necessarily indicative of future results of the Company because, among other things, the Acquired Companies were not under common control or management prior to their acquisition.

The timing and magnitude of acquisitions, assimilation costs, and the seasonal nature of the HVAC industry may materially affect operating results. Accordingly, the operating results for any period are not necessarily indicative of the results that may be achieved for any subsequent period.

PRO FORMA COMBINED RESULTS OF OPERATIONS

The following unaudited pro forma combined information is presented supplementally to reflect the pro forma results of operations as if the acquisition of the Founding Companies occurred on January 1, 1997, as reflected in the Company's publicly disclosed earnings announcements. Therefore, the accompanying unaudited pro forma combined statements of operations and the related management's discussion and analysis of the Company for the three and nine months ended September 30, 1998 and 1997, respectively, include the combined operations of the Pooled Companies and the Founding Companies from January 1, 1997, and the Purchased Companies from the dates of their acquisitions. One of the Pooled Companies is considered immaterial and has not been restated for all periods presented.

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The Acquired Companies were managed prior to their acquisitions as independent private companies. Therefore, historical selling, general and administrative expenses for the periods presented in the condensed consolidated financial statements of the Company reflect compensation and related benefits the owners of those businesses received prior to acquisition. Historical selling, general and administrative expenses also include the Compensation Charge recorded by the Company in the first quarter of 1997 related to Common Stock issued to management of and consultants to the Company prior to the IPO. The pro forma combined results of operations reflect: (i) the Compensation Differential of the Founding and Pooled Companies which the former owners of those companies agreed would take effect as of the date of acquisitions, (ii) pro forma combined compensation expense of \$430,000 for the nine months ended September 30, 1997 to reflect the ongoing salaries received by the corporate management as though those salaries were being paid prior to the IPO, (iii) interest expense on borrowings of \$11.0 million that would have been necessary to fund various S Corporation Distributions of the Founding Companies as if they had occurred on January 1, 1997, (iv) amortization of goodwill related to the Founding Companies, and (v) the elimination of the Compensation Charge referred to above. In addition, an incremental tax provision has been recorded as if all applicable Purchased and Founding Companies and the Pooled Companies, that were C Corporations, had been subject to federal and state income taxes.

PRO FORMA COMBINED (IN THOUSANDS)

	THREE MONTHS ENDED SEPTEMBER 30,				NINE MONTHS ENDED SEPTEMBER 30,			
	1997		1998		1997		1998	
Revenues .....	\$ 97,454	100.0%	\$ 232,381	100.0%	\$ 262,116	100.0%	\$ 559,339	100.0%
Cost of Services .....	70,249	72.1	175,308	75.4	191,066	72.9	423,223	75.7
Gross Profit .....	27,205	27.9	57,073	24.6	71,050	27.1	136,116	24.3
Selling, general and administrative expenses .....	15,513	15.9	33,663	14.5	44,466	17.0	85,845	15.3
Goodwill amortization .....	875	0.9	1,854	0.8	2,623	1.0	4,642	0.8
Operating income .....	10,817	11.1	21,556	9.3	23,961	9.1	45,629	8.2
Other income (expense) .....	54	--	(1,571)	(0.7)	(541)	(0.2)	(3,575)	(0.6)
Income before taxes .....	10,871	11.2	19,985	8.6	23,420	8.9	42,054	7.5
Provision for income taxes .....	4,378	--	8,698	--	9,390	--	18,394	--
Net income .....	\$ 6,493	6.7%	\$ 11,287	4.9%	\$ 14,030	5.4%	\$ 23,660	4.2%

PRO FORMA COMBINED REVENUES - Pro forma combined revenues increased \$134.9 million, or 138.5%, to \$232.4 million for the three months ended September 30, 1998 and increased \$297.2 million, or 113.4%, to \$559.3 million for the first nine months of 1998, compared to the same periods of the prior year. Revenues from the Founding Companies and Pooled Companies increased approximately 17% and 16% for the three months and nine months ended September 30, 1998, respectively, primarily due to greater demand for specialized multi-unit installation services in Texas and the Northeast, strong general activity in the Houston, Grand Rapids and Cincinnati markets and higher demand for commercial and industrial design and build services in the Company's Tennessee-based operations. The acquisition of the Purchased Companies, excluding "tuck-ins," acquired subsequent to the IPO through the end of the third quarter of 1998 contributed approximately \$114.0 million and \$240.9 million of revenue for the three months and nine months ended September 30, 1998, respectively.

PRO FORMA COMBINED GROSS PROFIT - Pro forma combined gross profit increased \$29.9 million, or 109.8%, to \$57.1 million for the three months ended September 30, 1998 and increased \$65.1 million, or 91.6%, to \$136.1 million for the first nine months of 1998, primarily due to increased revenues at the Founding Companies, the addition of the Purchased Companies and incremental increases in volume and gross margin at some of the Pooled Companies. As a percentage of revenues, pro forma combined gross profit decreased from 27.9% in the third quarter of 1997 to 24.6% in the third quarter of 1998 and decreased from 27.1% in the first nine months of 1997 to 24.3% in the first nine months of 1998. These declines

resulted primarily from the acquisition of the Purchased Companies, which, taken as a whole, have gross margins that are lower than the Company's historical average.

PRO FORMA COMBINED SELLING, GENERAL AND ADMINISTRATIVE EXPENSES (SG&A) Pro forma combined SG&A, excluding goodwill amortization, increased \$18.2 million,

or 117.0%, to \$33.7 million for the third quarter of 1998 and increased \$41.4 million or 93.1% to \$85.8 million for the first nine months of 1998. These increases were due principally to the addition of the Purchased Companies along with corporate office and management expenses associated with the Company's establishment as a public company. As a percentage of revenues, pro forma combined SG&A, excluding goodwill amortization, decreased from 15.9% to 14.5% in the third quarter of 1998, and from 17.0% to 15.3% in the first nine months of 1998, compared to the same period of the prior year. This decrease is due to the Company's acquisition of the Purchased Companies, which, taken as a whole, have SG&A as a percentage of revenues that is lower than the Company's historical average.

PRO FORMA COMBINED OTHER INCOME (EXPENSE) - Pro forma combined other expense, net increased to \$1.6 million for the third quarter of 1998 and to \$3.6 million for the first nine months of 1998 primarily due to the increase in interest expense related to the acquisition of the Purchased Companies acquired subsequent to the IPO through the end of the third quarter of 1998.

#### HISTORICAL RESULTS OF OPERATIONS (IN THOUSANDS)

	THREE MONTHS ENDED SEPTEMBER 30,				NINE MONTHS ENDED SEPTEMBER 30,			
	1997		1998		1997		1998	
Revenues .....	\$ 97,454	100.0%	\$ 232,381	100.0%	\$ 175,411	100.0%	\$ 559,339	100.0%
Cost of Services .....	70,249	72.1	175,308	75.4	128,481	73.2	423,223	75.7
Gross Profit .....	27,205	27.9	57,073	24.6	46,930	26.8	136,116	24.3
Selling, general and administrative expenses ..	17,832	18.3	34,405	14.8	46,758	26.7	87,609	15.7
Goodwill amortization .....	883	0.9	1,854	0.8	883	0.5	4,642	0.8
Operating income (loss) ....	8,490	8.7	20,814	9.0	(711)	(0.4)	43,865	7.8
Other income (expense) .....	49	0.1	(1,571)	(0.7)	(29)	--	(3,575)	(0.6)
Income (loss) before taxes .	8,539	8.8	19,243	8.3	(740)	(0.4)	40,290	7.2
Provision for income taxes .	4,899	--	8,444	--	4,575	--	17,687	--
Net income (loss) .....	\$ 3,640	3.7%	\$ 10,799	4.6%	\$ (5,315)	(3.0)%	\$ 22,603	4.0%

REVENUES - Revenues increased \$134.9 million, or 138.5%, to \$232.4 million for the three months ended September 30, 1998 and increased \$383.9 million, or 218.9%, to \$559.3 million for the first nine months of 1998, compared to the same periods of the prior year. The increase in revenues was primarily due to the acquisition of the Founding Companies and Purchased Companies.

GROSS PROFIT - Gross profit increased \$29.9 million, or 109.8%, to \$57.1 for the three months ended September 30, 1998 and increased \$89.2 million, or 190.0%, to \$136.1 million for the first nine months of 1998, compared to the same periods of the prior year. The increase in gross profit was primarily due to the acquisitions described above. As a percentage of revenues, gross profit decreased from 27.9% in the third quarter of 1997 to 24.6% in the third quarter of 1998 and from 26.8% in the first nine months of 1997 to 24.3% in the first nine months of 1998. These declines resulted primarily from the acquisition of the Purchased Companies, which, taken as a whole, have gross margins that are lower than the Company's historical average.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES - SG&A, excluding goodwill amortization, for the three months and nine months ended September 30, 1997 includes \$2.1 million and \$7.3 million, respectively, and the three months and nine months ended September 30, 1998 includes \$0.7 million and \$1.8 million, respectively, of Compensation Differential and acquisition related costs which will be eliminated prospectively. Additionally, the Company recorded the

non-recurring, non-cash Compensation Charge of \$11.6 million in the first quarter of 1997. Excluding the Compensation Differential, the Compensation Charge, and goodwill amortization, SG&A increased \$18 million, to \$33.7 million for the three months ended September 30, 1998 and increased \$46.4 million to \$85.8 million for the nine months ended September 30, 1998. Most of this increase was related to the Founding Companies and Purchased Companies acquired since the IPO along with corporate office and management expenses associated with the Company's establishment as a public company.

OTHER INCOME (EXPENSE) - Other expense, net increased to \$1.6 million and \$3.6 million for the three months and nine months ended September 30, 1998 primarily due to the increase in interest expense related to the acquisition of the Purchased Companies.

## LIQUIDITY AND CAPITAL RESOURCES - HISTORICAL

For the nine months ended September 30, 1998, net cash used in operating activities was \$19.9 million due to a decrease in accounts payable and accrued liabilities of \$3.6 million and an increase in accounts receivables of \$39.3 million. Accounts payable balances decreased from the date of acquisition at various locations as certain companies took advantage of the consolidated cash management system to receive cash discounts for early payments. The increase in receivables is due, in part, to the higher levels of seasonal operating activity that the Company experiences in the second and third quarters.

Cash used in investing activities was \$69.1 million for the nine months ended September 30, 1998, primarily in connection with the acquisition of the Acquired Companies for \$62.7 million, net of cash acquired. The remainder of cash used in the investing activities was for additions to equipment.

Cash provided by financing activities for the nine months ended September 30, 1998 was \$80.5 million and was primarily attributable to the net borrowings of long-term debt.

At September 30, 1998, working capital was \$117.4 million and total debt outstanding was \$134.8 million.

Subsequent to September 30, 1998, and through November 16, 1998, the Company completed the acquisition of 7 companies for approximately \$83.8 million in cash, 2,646,508 shares of Common Stock and \$33.4 million in Notes. All of these acquisitions will be accounted for as purchase transactions.

In July 1997, the Company entered into the Credit Facility with Bank One, Texas, N.A. which was amended and restated in September 1997 primarily to provide for additional banks to lend to the Company. The Credit Facility was further amended in April 1998 to increase borrowing capacity and to provide for additional banks to lend to the Company. The Credit Facility provides the Company with an unsecured revolving line of credit of \$175 million. The Company has a choice of two interest rate options when borrowing under the Credit Facility. Under one option, the interest rate is determined based on the higher of the Federal Funds Rate plus one-half percentage point or the bank's prime rate. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate LIBOR) plus 0.75 to 1.5 percentage points. The amount of percentage points added depends on the ratio of the Company's debt to EBITDA for the preceding twelve months. For purposes of this ratio, EBITDA may include the preceding twelve months' results for any companies acquired during the last year. In addition, commitment fees of 0.125% to 0.325% per annum, also depending on the ratio of debt to EBITDA, are payable on the unused portion of the Credit Facility. The Credit Facility prohibits the payment of dividends by the Company without lender's approval and requires the Company to comply with certain financial covenants. The Credit Facility expires on April 14, 2001, at which time, all amounts outstanding under the facility are due. As of September 30, 1998, \$103.9 million was outstanding under the Credit Facility. As of November 10, 1998, \$105.8 million was outstanding under the Credit Facility.

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The Company intends to pursue additional acquisition opportunities, the cash portion of which will be financed with borrowings under the Credit Facility as well as cash flow from operations. The Company anticipates that cash flow from operations will provide cash in excess of the Company's normal working capital needs, debt service requirements and planned capital expenditures for equipment. Should the Company accelerate or revise its acquisition program, the Company may need to seek financing in addition to the Credit Facility through the public or private sale of equity or debt securities. There can be no assurance that the Company can secure financing if and when needed, or that such financing will be available on terms the Company deems acceptable.

## YEAR 2000

Computers, software, and other equipment utilizing microprocessors that use only two digits to identify a year in a date field may be unable to accurately process certain date-based information at or after the year 2000. This is commonly referred to as the "Year 2000 issue." The Company has implemented a Year 2000 program and is using both internal and external resources to assess and replace or reprogram computers, software and other equipment as needed. Key areas of the Company's operations that are being addressed include external

customers, external suppliers and internal computers, software and other equipment.

Year 2000 considerations may have an effect on some of the Company's customers and suppliers, and thus indirectly on the Company. The Company is assessing the potential effect on the Company with respect to customers and suppliers with Year 2000 issues and does not expect a material effect on the Company's financial condition or results of operations at this time. The Company has initiated communications with its significant customers and suppliers to assess the extent to which the Company is vulnerable to those third parties with which the Company transacts business.

The Company's initial assessment identified Year 2000 issues within the Company's operating systems. The total cost of anticipated Year 2000 enhancements is approximately \$500,000 and is being funded from operating cash flows. The majority of such costs is for the enhancement of hardware and software and will be capitalized. The remaining costs will be expensed as incurred and are not expected to have a material effect on the results of operations. The Company expects, but cannot provide assurance, to be substantially complete with Year 2000 enhancements for internal operating systems by June 1999, which is prior to any significant anticipated impact on its operating systems.

The ability of third parties with which the Company transacts business to adequately address Year 2000 issues is outside of the Company's control. There can be no assurance that the failure of the Company, or such third parties, to adequately address their respective Year 2000 issues will not have a material adverse effect on the Company's financial condition or results of operations. At this time, the Company does not expect such an adverse impact.

#### SEASONALITY AND CYCLICALITY

The HVAC industry is subject to seasonal variations. Specifically, the demand for new installation and replacement is generally lower during the winter months 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, the Company expects its revenues and operating results generally will be lower in the first and fourth calendar quarters.

Historically, the construction industry has been highly cyclical. As a result, the Company's volume of business may be adversely affected by declines in new installation projects in various geographic regions of the United States.

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#### COMFORT SYSTEMS USA, INC. PART II -- OTHER INFORMATION

##### ITEM 1. LEGAL PROCEEDINGS

The Company is involved in various legal proceedings that have arisen in the ordinary course of business. The Company does not believe that any of these proceedings will have a material adverse effect on the financial position or results of operations of the Company.

##### ITEM 2. RECENT SALES OF UNREGISTERED SECURITIES

On September 30, 1998, the Company issued 718,391 unregistered shares of its Common Stock in connection with the acquisition of an HVAC business which was not material. These shares were issued without registration under the Securities Act in reliance on the exemption provided by Section 4(2), no public offering being involved.

##### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

###### (a) Exhibits

27.1 Financial Data Schedule. (Filed herewith)

###### (b) Reports on Form 8-K

None.



ITEM 9. CHANGES AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

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SIGNATURE

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.

By: /s/ J. GORDON BEITTENMILLER  
J. GORDON BEITTENMILLER  
EXECUTIVE VICE PRESIDENT AND  
CHIEF FINANCIAL OFFICER

Dated: November 16, 1998

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<ARTICLE> 5

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THE FINANCIAL DATA SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM FORM 10-Q NINE MONTHS ENDED SEPTEMBER 30, 1998 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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