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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
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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, 1999

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_

COMMISSION FILE NUMBER: 1-13011

COMFORT SYSTEMS USA, INC.  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE  
(STATE OR OTHER JURISDICTION  
OF INCORPORATION OR ORGANIZATION)

76-0526487  
(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

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 10, 1999, was 37,813,537.

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COMFORT SYSTEMS USA, INC.  
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FOR THE QUARTER ENDED SEPTEMBER 30, 1999

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

INTRODUCTION TO FINANCIAL STATEMENTS

Comfort Systems USA, Inc., a Delaware corporation ("Comfort Systems" and collectively with its subsidiaries, the "Company") is a leading national provider of comprehensive heating, ventilation and air conditioning ("HVAC") installation, 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 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 in providing HVAC services. The Founding Companies had 18 operating locations in 10 states. Subsequent to the IPO, and through September 30, 1999, the Company acquired 104 additional HVAC and complementary businesses (collectively with the Founding Companies, the "Acquired Companies"). Of these additional businesses acquired, 17 were accounted for as poolings-of-interests (the "Pooled Companies"). The remaining businesses acquired were accounted for as purchases (the "Purchased Companies"). The companies acquired subsequent to the IPO added 105 operating locations in 21 additional states. These acquisitions included 25 "tuck-in" operations that have been or are currently being integrated with existing Company operations.

Historical interim period results are not necessarily indicative of future results because, among other things, these Acquired Companies were not under common control or management prior to their acquisition by the Company. The Company's results of operations historically have been subject to seasonal fluctuations. 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 for the year ended December 31, 1998.

COMFORT SYSTEMS USA, INC.  
CONSOLIDATED BALANCE SHEETS  
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	DECEMBER 31, 1998	SEPTEMBER 30, 1999
	-----	-----
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents.....	\$ 6,985	\$ 7,602
Accounts receivable.....	241,332	301,924
Less -- Allowance.....	4,758	5,562
	-----	-----
Accounts receivable, net.....	236,574	296,362
Other receivables.....	2,733	5,892
Inventories.....	14,768	18,953
Prepaid expenses and other.....	14,264	20,013
Costs and estimated earnings in excess of billings.....	37,228	56,372
	-----	-----
Total current assets.....	312,552	405,194
PROPERTY AND EQUIPMENT, net.....	34,413	40,224
GOODWILL, less accumulated amortization of \$8,983 and \$17,595.....	430,526	471,052
OTHER NONCURRENT ASSETS.....	11,802	11,788
	-----	-----
Total assets.....	\$789,293	\$ 928,258
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt.....	\$ 1,568	\$ 4,785
Current maturities of notes to affiliates and former owners...	7,509	21,299
Accounts payable.....	74,161	88,837
Accrued compensation and benefits.....	25,869	31,290
Billings in excess of costs and estimated earnings.....	43,968	46,986
Income taxes payable.....	1,299	6,034
Other current liabilities.....	24,788	26,897
	-----	-----
Total current liabilities.....	179,162	226,128
DEFERRED INCOME TAXES.....	1,124	1,761
LONG-TERM DEBT, NET OF CURRENT MATURITIES.....	171,039	220,075
NOTES TO AFFILIATES AND FORMER OWNERS, NET OF CURRENT MATURITIES.....	56,330	55,915
OTHER LONG-TERM LIABILITIES.....	1,706	1,695
	-----	-----
Total liabilities.....	409,361	505,574
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, 38,141,180 and 39,251,677 shares issued and outstanding, respectively.....	381	393
Additional paid-in capital.....	333,978	342,641
Retained earnings.....	45,573	79,650
	-----	-----
Total stockholders' equity.....	379,932	422,684
	-----	-----
Total liabilities and stockholders' equity.....	\$789,293	\$ 928,258
	=====	=====

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

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

	THREE MONTHS ENDED SEPTEMBER 30,		NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1999	1998	1999
REVENUES.....	\$ 232,381	\$ 374,815	\$ 559,339	\$ 1,008,234
COST OF SERVICES.....	175,308	298,480	423,223	792,482
Gross profit.....	57,073	76,335	136,116	215,752
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES.....	34,405	45,793	87,609	133,984
GOODWILL AND OTHER AMORTIZATION.....	1,854	2,983	4,642	8,650
Operating income.....	20,814	27,559	43,865	73,118
OTHER INCOME (EXPENSE):				
Interest income.....	233	209	625	598
Interest expense.....	(1,941)	(5,265)	(4,356)	(14,078)
Other.....	137	89	156	192
Other income (expense).....	(1,571)	(4,967)	(3,575)	(13,288)
INCOME BEFORE INCOME TAXES.....	19,243	22,592	40,290	59,830
PROVISION FOR INCOME TAXES.....	8,444	9,724	17,687	25,753
NET INCOME.....	\$ 10,799	\$ 12,868	\$ 22,603	\$ 34,077
NET INCOME PER SHARE:				
Basic.....	\$ 0.32	\$ 0.33	\$ 0.71	\$ 0.88
Diluted.....	\$ 0.31	\$ 0.33	\$ 0.70	\$ 0.86
SHARES USED IN COMPUTING NET INCOME PER SHARE:				
Basic.....	33,964	39,060	31,689	38,705
Diluted.....	34,454	39,531	32,179	40,335

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

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

	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	TOTAL STOCKHOLDERS' EQUITY
	SHARES	AMOUNT			
BALANCE AT DECEMBER 31, 1997.....	28,013,436	\$ 280	\$ 205,829	\$ 11,526	\$217,635
Issuance of Common Stock:					
Proceeds of the Second Public Offering.....	861,479	9	15,892	--	15,901
Acquisition of Purchased Companies.....	9,212,573	92	111,456	--	111,548
Issuance of Employee Stock Purchase Plan shares.....	29,362	--	482	--	482
Issuance of shares for options exercised.....	24,330	--	319	--	319
S Corporation distributions made by certain Pooled Companies.....	--	--	--	(966)	(966)
Net income.....	--	--	--	35,013	35,013
	-----	-----	-----	-----	-----
BALANCE AT DECEMBER 31, 1998.....	38,141,180	381	333,978	45,573	379,932
Issuance of Common Stock:					
Acquisition of Purchased Companies (unaudited).....	951,297	10	6,407	--	6,417
Issuance of Employee Stock Purchase Plan shares (unaudited).....	142,276	2	2,036	--	2,038
Issuance of shares for options exercised (unaudited).....	16,924	--	220	--	220
Net income (unaudited).....	--	--	--	34,077	34,077
	-----	-----	-----	-----	-----
BALANCE AT SEPTEMBER 30, 1999 (unaudited).....	39,251,677	\$ 393	\$ 342,641	\$ 79,650	\$422,684
	=====	=====	=====	=====	=====

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

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

	NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1999
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income.....	\$ 22,603	\$ 34,077
Adjustments to reconcile net income to net cash provided by (used in) operating activities --		
Depreciation and amortization expense.....	9,219	16,955
Bad debt expense.....	384	656
Deferred tax benefit.....	(118)	(639)
Gain on sale of property and equipment.....	(158)	(280)
Changes in operating assets and liabilities, net of effects of acquisitions of Purchased Companies --		
(Increase) decrease in --		
Receivables, net.....	(39,302)	(46,153)
Inventories.....	(1,420)	(3,032)
Prepaid expenses and other current assets.....	(6,744)	(41)
Costs and estimated earnings in excess of billings.....	(4,241)	(17,294)
Other noncurrent assets.....	499	1,076
Increase (decrease) in --		
Accounts payable and accrued liabilities.....	(3,642)	16,875
Billings in excess of costs and estimated earnings.....	4,299	1,074
Other, net.....	(1,262)	(1,001)
Net cash provided by (used in) operating activities.....	(19,883)	2,273
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Purchases of property and equipment.....	(7,069)	(11,360)
Proceeds from sales of property and equipment.....	699	1,020
Cash paid for Purchased Companies, net of cash acquired.....	(62,683)	(27,448)
Other.....	--	(500)
Net cash used in investing activities.....	(69,053)	(38,288)
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Payments on long-term debt.....	(63,185)	(154,486)
Borrowings of long-term debt....	127,928	188,860
S Corporation distributions paid by certain Pooled Companies....	(821)	--
Proceeds from issuance of common stock.....	16,604	2,258
Net cash provided by financing activities....	80,526	36,632
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....</b>	<b>(8,410)</b>	<b>617</b>
CASH AND CASH EQUIVALENTS, beginning of period.....	18,097	6,985
CASH AND CASH EQUIVALENTS, end of period.....	\$ 9,687	\$ 7,602
	=====	=====

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

COMFORT SYSTEMS USA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 1999  
(UNAUDITED)

1. BUSINESS AND ORGANIZATION:

Comfort Systems USA, Inc., a Delaware corporation ("Comfort Systems" and collectively with its subsidiaries, the "Company"), is a leading national provider of comprehensive heating, ventilation and air conditioning ("HVAC") installation, 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 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 in providing HVAC services. The Founding Companies had 18 operating locations in 10 states. Subsequent to the IPO, and through September 30, 1999, the Company acquired 104 additional HVAC and complementary businesses (collectively with the Founding Companies, the "Acquired Companies"). Of these additional businesses acquired, 17 were accounted for as poolings-of-interests (the "Pooled Companies"). The remaining businesses acquired were accounted for as purchases (the "Purchased Companies"). The companies acquired subsequent to the IPO added 105 operating locations in 21 additional states. These acquisitions included 25 "tuck-in" operations that have been or are currently being integrated with existing Company operations.

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 for the year ended December 31, 1998.

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, 1998.

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, 1998 and 1999 was approximately \$3.7 million and \$12.0 million, respectively. Cash paid for income taxes for the nine months ended September 30, 1998 and 1999 was approximately \$21.2 million and \$23.0 million, respectively.

3. BUSINESS COMBINATIONS:

POOLINGS

During 1998, the Company acquired all of the outstanding stock of three of the Pooled Companies in exchange for 1,437,767 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 Annual Report on Form 10-K as filed with the Securities and Exchange Commission for the year ended December 31, 1998. These companies provide HVAC and related services.

There were no acquisitions for the nine months ended September 30, 1999 which were accounted for as poolings-of-interests.

PURCHASES

During 1998, the Company acquired 52 of the Purchased Companies. These companies provide HVAC and related services. The aggregate consideration paid in these transactions was \$161.2 million in cash, 9,212,573 shares of Common Stock with a market value at the date of acquisition totaling \$111.5 million, \$57.4 million in the form of convertible subordinated notes and \$3.1 million in the form of subordinated notes (collectively the "Notes"). Subsequent to the issuance of certain of the convertible subordinated notes, the Company entered into agreements with certain of the convertible noteholders to modify the terms of \$49.3 million of these notes in order to eliminate the provisions relating to convertibility into the Company's Common Stock. The remaining convertible subordinated notes are convertible at various dates in 1999 and 2000 into 28,965 and 53,655 shares of Common Stock, respectively. Prior to 1998, convertible subordinated notes were issued to certain Purchased Companies and are convertible at various dates in 1999 into 121,413 shares of Common Stock.

For the nine months ended September 30, 1999, Comfort Systems acquired 22 additional companies, which were accounted for as purchase transactions. These companies provide HVAC and related services. The aggregate consideration paid in these transactions was approximately \$33.6 million in cash, 1,027,248 shares of Common Stock with a market value at the date of acquisition totaling \$7.5 million, approximately \$2.2 million in the form of convertible subordinated notes and \$18.9 million in the form of subordinated notes. Subsequent to the issuance of certain of the convertible subordinated notes, the Company entered into agreements with certain of the convertible noteholders to modify the terms of \$0.7 million of these notes in order to eliminate the provisions relating to convertibility into the Company's Common Stock. The remaining convertible subordinated notes are convertible at various dates in 2000 into 62,276 shares of Common Stock. The allocation of the respective purchase prices to the assets acquired and liabilities assumed resulted in \$51.8 million of goodwill related to the companies acquired during the first nine months of 1999.

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 are subject to final adjustment.

COMFORT SYSTEMS USA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 1999 -- (CONTINUED)

The unaudited pro forma data presented below consist of the income statement data presented in these consolidated financial statements plus income statement data for the Purchased Companies as if the acquisitions were effective on January 1, 1998 through the respective dates of acquisitions (in thousands, except per share data):

	NINE MONTHS ENDED SEPTEMBER 30,	
	1998	1999
Revenues.....	\$ 986,035	\$ 1,049,570
Net income.....	\$ 31,332	\$ 34,366
Net income per share -- diluted.....	\$ 0.80	\$ 0.86
Shares used in computing net income per share -- diluted.....	38,953	40,797

Pro forma adjustments included in the preceding table regarding the Acquired Companies primarily relate to (a) certain reductions in salaries and benefits to the former owners (the "Compensation Differential") of the Pooled Companies and Purchased Companies which the former owners agreed would take effect as of the acquisition date, (b) elimination of merger costs in connection with the acquisition of the Pooled Companies, (c) amortization of goodwill related to the Purchased Companies, (d) interest expense on borrowings of \$11.8 million that would have been necessary to fund certain S Corporation distributions if they had occurred at the beginning of each period presented, (e) interest expense on borrowings of \$116.4 million related to the purchase price of the Purchased Companies acquired during 1998 and the first nine months of 1999 and (f) interest expense related to \$57.1 million of subordinated 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 Companies and Pooled Companies which were C Corporations had been subject to federal and state income taxes.

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

4. LONG-TERM DEBT OBLIGATIONS:

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

	DECEMBER 31, 1998	SEPTEMBER 30, 1999
		(UNAUDITED)
Revolving credit facility.....	\$ 170,700	\$219,900
Notes to affiliates and former owners.....	63,839	77,214
Other.....	1,907	4,960
Total debt.....	236,446	302,074
Less: current maturities.....	9,077	26,084
	\$ 227,369	\$275,990

REVOLVING CREDIT AGREEMENT

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. At that time, the Credit Facility provided the Company with an unsecured revolving line of credit of \$75 million. The Credit Facility was further amended in April 1998 and again in December 1998 in order to increase borrowing capacity and to provide

COMFORT SYSTEMS USA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 1999 -- (CONTINUED)

for additional banks to lend to the Company under the Credit Facility. The Credit Facility currently provides the Company with a revolving line of credit up to \$300 million secured by accounts receivable, inventory and the shares of capital stock of the Company's subsidiaries. The Company currently 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 0.5% or the bank's prime rate. An additional margin of zero to 1.25% is then added to the higher of these two rates. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate LIBOR) plus 1.0% to 2.5%. The additional margin for both options depends on the ratio of the Company's debt to EBITDA. Commitment fees of 0.25% to 0.5% 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 the lenders' approval and requires the Company to comply with certain financial covenants. The amended Credit Facility expires on November 1, 2001, at which time all amounts outstanding under the Credit Facility are due.

As of September 30, 1999, the Company had borrowed \$219.9 million under the Credit Facility at an average interest rate of approximately 7.0% per annum for the first nine months of 1999. As of November 10, 1999, \$229.1 million was outstanding under this facility.

NOTES TO AFFILIATES AND FORMER OWNERS

The Notes in the amount of \$77.2 million, net of \$9.4 million of repayments, referred to above were issued to former owners of certain Purchased Companies as partial consideration of the acquisition purchase price. Of these Notes, \$76.7 million bear interest, payable quarterly, at a weighted average interest rate of 5.84% and \$6.3 million are convertible by the holders into shares of the Company's Common Stock at a weighted average price of \$23.78 per share. The remaining Notes in the amount of \$0.5 million are non-interest bearing with the remaining principal payments due in four equal annual installments beginning in 2000. The terms of the convertible subordinated notes require \$0.2 million of principal payments in 1999, \$3.2 million of principal payments in 2000, \$0.6 million of principal payments in 2001, \$1.9 million of principal payments in 2002 and \$0.4 million of principal payments in 2003. The terms of the nonconvertible interest-bearing subordinated notes require \$2.3 million of principal payments in 1999, \$20.1 million of principal payments in 2000, \$29.2 million of principal payments in 2001 and \$18.8 million of principal payments in 2002.

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. A wholly-owned insurance company subsidiary reinsures a portion of the risk associated with surety bonds issued by a third party insurance company. Because no claims have been made against these financial instruments in the past, management does not expect these instruments will have a material effect on the Company's consolidated financial statements.

6. STOCKHOLDERS' EQUITY:

COMMON STOCK AND PREFERRED STOCK

During 1998, the Company increased the number of authorized shares of Common Stock to 102,969,912. 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, after deducting underwriting commissions, were used to repay debt. On July 21, 1998, the underwriters exercised their overallotment option in connection with the Second Public Offering completed in June 1998. An additional 461,479 shares of Common Stock were sold and the net proceeds of \$8.8 million, after deducting underwriting commissions, were used to repay debt.

RESTRICTED COMMON STOCK

In March 1997, Notre Capital Ventures II, L.L.C. ("Notre") exchanged 2,742,912 shares of Common Stock for an equal number of shares of restricted voting common stock ("Restricted Voting Common Stock"). The holders of Restricted Voting Common Stock are entitled to elect one member of the Company's Board of Directors and 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. As of September 30, 1999, 736,335 shares of Restricted Voting Common Stock had been converted to shares of Common Stock.

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 and convertible subordinated notes. Options to purchase 2.3 million shares of Common Stock at prices ranging from \$15.375 to \$21.438 per share and options to purchase 2.0 million shares of Common Stock at prices ranging from \$15.875 to \$21.438 per share were outstanding for the three months and nine months ended September 30, 1999, respectively, but were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the respective average market price of the Common Stock. Diluted EPS is also computed by adjusting both net earnings and shares outstanding as if the conversion of the convertible subordinated notes occurred on the first day of the year. The after tax interest expense related to the assumed conversion of the convertible subordinated notes during the three months and nine months ended September 30, 1999 was \$52,000 and \$757,000, respectively. The effect of the assumed conversion of the convertible subordinated notes during the first nine months of 1998 was antidilutive.

COMFORT SYSTEMS USA, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
SEPTEMBER 30, 1999 -- (CONTINUED)

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,	
	1998	1999	1998	1999
Shares issued in connection with the acquisitions of the Founding Companies.....	9,721	9,721	9,721	9,721
Shares sold pursuant to the IPO.....	6,100	6,100	6,100	6,100
Shares held by Notre, management and consultants.....	4,240	4,240	4,240	4,240
Shares issued in connection with the acquisitions of the Pooled Companies.....	5,946	5,946	5,946	5,946
Weighted average shares issued in connection with the underwriter's over-allotment.....	1,276	1,376	1,037	1,376
Weighted average shares issued in connection with the acquisitions of the Purchased Companies.....	6,245	11,098	4,482	10,794
Weighted average shares sold in the Second Public Offering.....	400	400	152	400
Weighted average portion of shares issued in connection with the Employee Stock Purchase Plan.....	20	142	6	98
Weighted average portion of shares issued in connection with the exercise of stock options.....	16	37	5	30
Weighted average shares outstanding -- Basic.....	33,964	39,060	31,689	38,705
Weighted average portion of shares related to stock options under the treasury stock method.....	490	202	490	228
Weighted average shares related to the issuance of convertible notes.....	--	269	--	1,402
Weighted average shares outstanding -- Diluted.....	34,454	39,531	32,179	40,335

7. SUBSEQUENT EVENTS:

On October 5, 1999, the Company announced that its Board of Directors had approved a share repurchase program authorizing the Company to buy up to 4 million shares of its Common Stock. As of November 10, 1999, the Company has purchased approximately 1.5 million shares at a cost of approximately \$10.5 million.

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, 1998 (the "Form 10-K"). This discussion contains forward-looking statements regarding the business and industry of Comfort Systems 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, 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 the IPO and simultaneously acquired the 12 Founding Companies, which are engaged in providing HVAC services. Subsequent to the IPO, and through September 30, 1999, the Company acquired 104 additional HVAC and complementary businesses. Of these additional businesses, 17 were accounted for as poolings-of-interests and the remaining businesses were accounted for as purchases. The consolidated historical financial statements of the Company have been retroactively restated to give effect to the operations of the Pooled Companies.

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 results of the Company have historically been subject to seasonal fluctuations. 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. These historical statements of operations should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems, filed herewith, and the additional information and the respective 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 for the year ended December 31, 1998.

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

	THREE MONTHS ENDED SEPTEMBER 30,				NINE MONTHS ENDED SEPTEMBER 30,			
	1998		1999		1998		1999	
Revenues.....	\$ 232,381	100.0%	\$ 374,815	100.0%	\$ 559,339	100.0%	\$ 1,008,234	100.0%
Cost of services.....	175,308	75.4	298,480	79.6	423,223	75.7	792,482	78.6
Gross profit.....	57,073	24.6	76,335	20.4	136,116	24.3	215,752	21.4
Selling, general and administrative expenses.....	34,405	14.8	45,793	12.2	87,609	15.7	133,984	13.3
Goodwill amortization.....	1,854	0.8	2,983	0.8	4,642	0.8	8,650	0.9
Operating income.....	20,814	9.0	27,559	7.4	43,865	7.8	73,118	7.3
Other income (expense).....	(1,571)	(0.7)	(4,967)	(1.3)	(3,575)	(0.6)	(13,288)	(1.3)
Income before taxes.....	19,243	8.3	22,592	6.0	40,290	7.2	59,830	5.9
Provision for income taxes.....	8,444	--	9,724	--	17,687	--	25,753	--
Net income.....	\$ 10,799	4.6%	\$ 12,868	3.4%	\$ 22,603	4.0%	\$ 34,077	3.4%

REVENUES -- Revenues increased \$142.4 million, or 61.3%, to \$374.8 million for the third quarter of 1999 and increased \$448.9 million, or 80.3%, to \$1.0 billion for the first nine months of 1999, compared to the same periods in 1998. The increase in revenues was primarily due to the acquisition of Purchased Companies; however, the Company has experienced a decline in internal revenue growth from previous periods. The Company believes that this is primarily attributable to a slowing in the growth of the construction industry due to shortages in both labor and specialty building materials, which in turn impacted HVAC installations.

GROSS PROFIT -- Gross profit increased \$19.3 million, or 33.7%, to \$76.3 million for the third quarter of 1999 and increased \$79.6 million, or 58.5%, to \$215.8 million for the first nine months of 1999, compared to the same periods in 1998. This increase was primarily due to the acquisitions described above. As a percentage of revenues, gross profit decreased from 24.6% for the three months ended September 30, 1998 to 20.4% for the three months ended September 30, 1999 and from 24.3% for the first nine months of 1998 to 21.4% for the first nine months of 1999. This decrease primarily resulted from the reclassification of certain costs from selling, general and administrative expenses to cost of services. These costs relate to activities that directly support project or service work. This reclassification better aligns the presentation of cost of services and selling, general and administrative expenses across all of our acquired operations. Excluding the effect of this reclassification for the three months and nine months ended September 30, 1999 of approximately \$7.3 million and \$21.0 million, respectively, gross profit as a percentage of revenues decreased from 24.6% for the third quarter of 1998 to 22.3% for the third quarter of 1999 and decreased from 24.3% for the first nine months of 1998 to 23.5% for the first nine months of 1999. This decrease in gross profit as a percentage of revenues resulted from lower internal revenue growth as a result of construction industry capacity issues as discussed above. In addition, there has been a shift in the mix of installation projects to higher labor-intensive projects with lower gross profit percentages, pricing competition in certain markets and execution shortfalls and inefficiencies as the Company sought stronger revenue growth levels. Hurricane Floyd also affected results as a number of the Company's eastern seaboard locations saw temporary halts in activity in connection with the storm.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES ("SG&A") -- SG&A increased \$11.4 million, or 33.1%, to \$45.8 million for the third quarter of 1999 and increased \$46.4 million, or 52.9%, to \$134.0 million for the first nine months of 1999, compared to the same periods in 1998. Most of this increase was related to Purchased Companies acquired subsequent to third quarter 1998 along with an increase in corporate personnel and corporate office expenses commensurate with the increase in the number of Acquired Companies. As a percentage of revenues, selling, general and administrative expenses decreased from 14.8% for the three months ended September 30, 1998 to 12.2% for the three months ended September 30, 1999 and from 15.7% for the first nine months of 1998 to 13.3% for the first nine months of 1999. This decrease is primarily attributable to the reclassification of costs as described above. Excluding

the effect of this reclassification for the three months and nine months ended September 30, 1999 of approximately \$7.3 million and \$21.0 million, respectively, SG&A expenses as a percentage of revenues decreased from 14.8% for the third quarter of 1998 to 14.2% for the third quarter of 1999 and decreased from 15.7% for the first nine months of 1998 to 15.4% for the first nine months of 1999. This decrease in SG&A as a percentage of revenues resulted from increased volume without a commensurate increase in overhead even though the Company experienced higher medical costs as a result of initiating a national health insurance program. SG&A for the third quarter of 1998 and the first nine months of 1998 includes \$0.7 million and \$1.8 million, respectively, of salaries and benefits paid to the former owners of the Pooled Companies which the former owners contractually agreed would not continue following their acquisition by Comfort Systems.

OPERATING INCOME -- Operating income increased \$6.7 million, or 32.4%, to \$27.6 million for the third quarter of 1999 and increased \$29.3 million, or 66.7%, to \$73.1 million for the first nine months of 1999, compared to the same periods in 1998. This increase was primarily due to the addition of Purchased Companies. As a percentage of revenues, operating income decreased from 9.0% for the three months ended September 30, 1998 to 7.4% for the three months ended September 30, 1999, and decreased from 7.8% for the nine months ended September 30, 1998 to 7.3% for the nine months ended September 30, 1999. The decrease in operating income as a percentage of revenues resulted from issues discussed above.

OTHER INCOME (EXPENSE) -- Other expense, net, increased to \$5.0 million and \$13.3 million for the three months and nine months ended September 30, 1999 primarily due to the increase in interest expense related to the acquisition of Purchased Companies subsequent to the third quarter of 1998.

#### LIQUIDITY AND CAPITAL RESOURCES -- HISTORICAL

For the nine months ended September 30, 1999, net cash provided by operating activities was \$2.3 million which reflects a typical increase in working capital investment in the second and third calendar quarters as a result of higher activity levels on a seasonal basis. This is an increase of \$22.2 million over the comparable period of the prior year when cash used in operating activities was \$19.9 million primarily as a result of a decrease in accounts payable and accrued liabilities and an increase in accounts receivable.

Cash used in investing activities was \$38.3 million for the nine months ended September 30, 1999, primarily in connection with the acquisition of Purchased Companies for \$27.4 million, net of cash acquired. Cash used in investing activities for the nine months ended September 30, 1998 was \$69.1 million, primarily for the acquisition of Purchased Companies.

Cash provided by financing activities for the nine months ended September 30, 1999 was \$36.6 million and was primarily attributable to net borrowings of long-term debt of \$34.4 million, which were primarily used to fund acquisitions. Net cash provided by financing activities for the nine months ended September 30, 1998 was \$80.5 million and was primarily attributable to net borrowings of long-term debt related to the acquisition of Purchased Companies.

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. At that time, the Credit Facility provided the Company with an unsecured revolving line of credit of \$75 million. The Credit Facility was further amended in April 1998 and again in December 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 currently provides the Company with a revolving line of credit up to \$300 million secured by accounts receivable, inventory and the shares of capital stock of the Company's subsidiaries. The Company currently 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 0.5% or the bank's prime rate. An additional margin of zero to 1.25% is then added to the higher of these two rates. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate LIBOR) plus 1.0% to 2.5%. The additional margin for both options depends on the ratio of the Company's debt to EBITDA. Commitment fees of 0.25% to 0.5% 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 the lenders' approval and requires the Company to comply with certain financial covenants. The amended Credit Facility expires on November 1, 2001, at which time all amounts outstanding under the Credit Facility are due.

As of September 30, 1999, the Company had borrowed \$219.9 million under the Credit Facility at an average interest rate of approximately 7.0% per annum for the first nine months of 1999. As of November 10, 1999, \$229.1 million was outstanding under this facility.

On October 5, 1999, the Company announced that its Board of Directors had approved a share repurchase program authorizing the Company to buy up to 4 million shares of its Common Stock. As of November 10, 1999, the Company has purchased approximately 1.5 million shares at a cost of approximately \$10.5 million.

The Company anticipates that available borrowings under its Credit Facility and cash flow from operations will provide cash in excess of the Company's normal working capital and capital expenditure needs, debt service requirements and additional acquisition opportunities. Should the Company accelerate or revise its acquisition program, the Company may need to seek additional financing through the public or private sale of equity or debt securities or increase its Credit Facility. There can be no assurance that the Company will secure such financing if and when it is needed, or that such financing will be available on terms that the Company deems acceptable.

#### YEAR 2000

Computers, software, and other equipment utilizing embedded technology 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 potential back-up and contingency plans.

Year 2000 considerations may have an effect on some of the Company's customers and suppliers, and thus indirectly on the Company. If the Company's vendors or suppliers of the Company's necessary dispatching, power, telecommunications, transportation and financial services fail to provide the Company with equipment and service, the Company will be unable to provide services to its customers. If any of these uncertainties were to occur, the Company's business, financial condition and results of operations could be materially adversely affected. The Company is completing its assessment of the potential effect on the Company with respect to customers and suppliers with Year 2000 issues and does not currently expect a material effect on the Company's financial condition or results of operations at this time.

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 \$800,000 and is being funded from operating cash flows. The majority of such costs is for the acquisition 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 be certain, that it will be substantially complete with Year 2000 enhancements for internal operating systems by November 1999.

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. Accordingly, as part of the Year 2000 program, contingency plans are being assessed and developed to respond to any failures as they may occur. At this time, the Company does not expect that any failure of the Company or third parties to achieve Year 2000 compliance will adversely affect the Company.

## 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.

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

During the three month period ended September 30, 1999, the Company did not issue any unregistered shares of its Common Stock in connection with acquisitions.

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.

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,  
CHIEF FINANCIAL OFFICER AND  
DIRECTOR

Dated: November 12, 1999

THE FINANCIAL DATA SCHEDULE CONTAINS SUMMARY FINANCIAL INFORMATION EXTRACTED FROM FORM 10-Q FOR THE THREE MONTHS ENDED SEPTEMBER 30, 1999 AND IS QUALIFIED IN ITS ENTIRETY BY REFERENCE TO SUCH FINANCIAL STATEMENTS.

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	SEP-30-1999	
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		301,924
		5,562
		18,953
		405,194
		95,084
		(54,860)
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226,128		275,990
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		0
		393
		422,291
928,258		
		1,008,234
		1,008,234
		792,482
		792,482
		141,978
		656
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		0.86