



Eaglewing Research

AI-Augmented Equity Research

EAGLEWING INVESTMENT THESIS

Watsco Inc

WSO | Fundamental Dislocations

Report date: 4 October 2026

Evidence cutoff: 4 October 2026 at 14:28 UTC

Our investment thesis, valuation scenarios and key risks over a 12-24 month horizon. The analysis reflects the evidence available at the stated cutoff. Outcomes are uncertain and outperformance is not guaranteed.

Investment overview

Watsco, Inc. is the largest wholesale distributor of heating, ventilation, air conditioning, and refrigeration (HVAC/R) equipment, parts, and supplies in North America, operating 723 branch locations across 43 U.S. states, Canada, Mexico, and Puerto Rico. The business distributes residential and commercial systems to more than 130,000 licensed contractors, maintaining leading local branch density and vendor relationships that make it an essential supply partner for short-notice equipment replacement and emergency repairs.

The central investment opportunity arises from a 35.2% peak-to-trough equity pullback from \$459.0 in April 2026 to \$297.5 in October 2026. The market has severely de-rated Watsco on fears of structural gross margin contraction following a 180 basis point year-over-year margin decline to 27.5% in the second quarter of 2026, alongside negative first-half operating cash flow of -\$21.4 million. In our analysis, this pullback misinterprets standard intra-year working capital seasonality as permanent cash drain and treats normal wholesale price-adjustment lags as structural impairment.

Our investment view is anchored by Watsco's secular demand foundation: an estimated 80% to 90% of residential air conditioning unit sales are non-discretionary replacements across an aging U.S. installed base of approximately 102 million systems in service for more than 10 years. In the second quarter of 2026, domestic residential unit volume expanded by 2.0% and average selling prices rose by 2.0%, proving that underlying replacement demand remains sound. Furthermore, Watsco holds \$464.2 million in liquid cash and short-term certificates of deposit, zero funded bank debt, and an undrawn \$600.0 million multicurrency credit facility.

The primary investment risk centers on supplier concentration and capital commitments. Carrier Global Corporation accounts for 62.0% of inventory purchases and its joint ventures represent 53.0% of consolidated revenues. Concurrently, Watsco faces substantial ongoing cash requirements, including an annualized dividend obligation of \$13.20 per share (consuming roughly \$504.1 million annually) and \$404.0 million in cash consideration required to close the pending acquisition of Granite Group Holdings. If wholesale gross margin recovery stalls at 27.0% or residential volume contracts sharply, balance sheet headroom would narrow.

EWRS assessment

88.4 / 100



Scores reflect our evidence-based assessment, not a probability of profit. Each bar shows points earned out of that dimension's maximum. Displayed values are rounded to one decimal place; totals use the unrounded scores. Read the scores alongside the valuation assumptions, risks and limitations; a high score does not guarantee investment success.

Our investment thesis

Over our 12-to-24-month horizon through March 2028, we expect Watsco to deliver attractive shareholder returns by re-establishing normalized operating margins of 10.4% and compound earnings through accretive acquisitions. Wholesale gross margins compressed to 27.5% in the second quarter of 2026 because distributor price realizations lagged OEM price actions enacted during 2025. As OEM price adjustments normalized during 2026, Watsco's dynamic pricing tools have begun realigning price schedules with procurement costs, paving the way for gross margins to return toward their historical through-cycle baseline of 28.2%.

The business benefits from powerful regulatory and commercial catalysts. The Environmental Protection Agency's final rule issued on May 26, 2026 eliminated installation bans on matching R-410A refrigerant systems effective July 26, 2026. This removed stranded inventory obsolescence risks and allowed Watsco to monetize existing inventory while selling higher-priced, lower global-warming-potential A2L systems. Simultaneously, digital platform adoption continues to outpace the industry, with e-commerce sales rising 13.0% year over year in the first half of 2026, engaging more than 70,000 contractors.

Watsco is accelerating consolidation in its fragmented industry. The company completed the acquisition of Jackson Supply Company on June 1, 2026, adding 25 Sunbelt branches and approximately \$230.0 million in annual sales for \$186.2 million in equity consideration. On September 12, 2026, it entered into a definitive merger agreement to acquire Granite Group Holdings for \$505.0 million (\$404.0 million in cash and approximately 324,257 shares), adding 82 branches and approximately \$500.0 million in Northeast plumbing and HVAC sales. Together, these transactions expand Watsco's top-line revenue by roughly 10.0% (\$730.0 million) with modest share dilution of only 2.2%.

Our fundamental scorecard awards Watsco a composite score of 88.4 out of 100 points, reflecting strong marks across financial resilience (13.9 out of 15.0), expectations dislocation (13.3 out of 15.0), and valuation (18.5 out of 20.0). Business durability achieved 12.2 out of 15.0 points due to near-term gross margin softness. We caution that this scorecard evaluates historical operating discipline, balance sheet liquidity, and scenario consistency; it is an analytical assessment rather than a mathematical guarantee of future equity returns.

What market expectations may be missing

The equity market has priced in a structural deterioration in Watsco's distribution economics that our analysis indicates is unfounded. Following second-quarter 2026 earnings, where gross profit fell 4.1% to \$578.9 million and diluted earnings per share dropped 11.5% to \$4.00, the stock suffered an aggressive multiple contraction. Reverse engineering the current share price of \$297.5 indicates that prevailing market expectations imply a permanent gross margin reset to 26.3% and perpetual volume growth of only 0.4%.

This pessimistic consensus overlooks the clear historical mechanics of HVAC wholesale distribution. In 2025, equipment manufacturers introduced aggressive price increases to counter raw material inflation and product changes for new refrigerant rules. Wholesale distributors face an unavoidable two-to-three quarter lag in updating customer price matrices and inventory costs. In 2026, OEM price hikes subsided to historical norms, allowing Watsco's gross economics to stabilize. The second-quarter domestic residential average selling price gain of 2.0% confirms that pricing power remains intact.

The market has also misinterpreted seasonal cash flow dynamics as operational cash burn. Negative operating cash flow of -\$21.4 million in the first half of 2026 was driven entirely by a seasonal inventory build of \$444.0 million and receivables expansion of \$244.6 million ahead of peak summer cooling demand. This seasonal working capital routinely unwinds into substantial cash generation in the third and fourth quarters. In 2025, Watsco generated \$569.6 million in operating cash flow and \$535.1 million in free cash flow, representing a 107.7% conversion of net income.

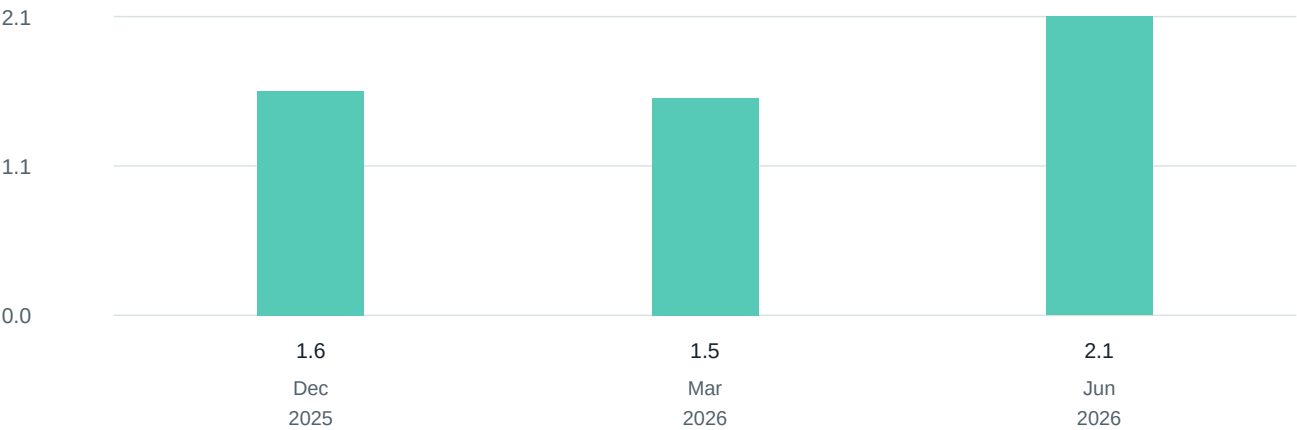
Business quality and financial condition

Watsco operates an asset-light distribution network comprising 723 branches, leasing almost all physical facilities under operating leases with rolling three-to-five-year terms. Its scale provides critical inventory availability that smaller distributors cannot match, supported by 1,100 experienced sales professionals. Branch density is especially strong in Sunbelt markets where cooling equipment experiences heavy usage and shorter operational lifespans: Florida accounts for 102 locations, Texas has 89, North Carolina has 54, and South Carolina has 53.

As of June 30, 2026, Watsco's balance sheet reflects exceptional resilience. The company held \$364.2 million in cash and cash equivalents (\$108.8 million in foreign subsidiaries) and \$100.0 million in short-term certificates of deposit, providing \$464.2 million in total liquid funds. Funded bank debt and debt securities remain zero, leaving the entire \$600.0 million multicurrency revolving credit facility undrawn through its maturity on March 16, 2028. Total lease liabilities under ASC 842 stand at \$535.3 million (\$119.7 million current).

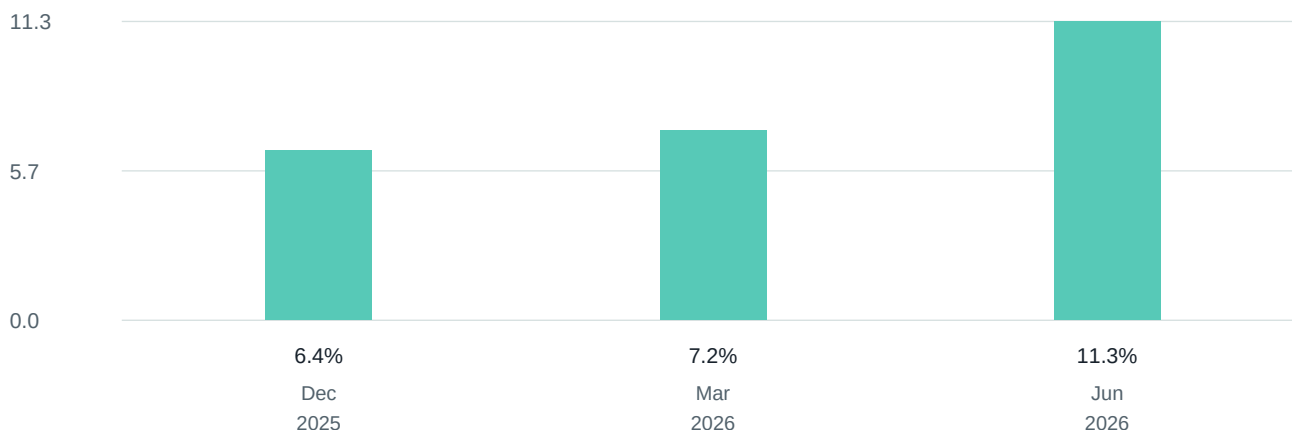
Capital expenditures are minimal, totaling \$34.6 million (0.5% of sales) in 2025 and \$15.95 million in the first half of 2026. This allows operating cash flow to convert directly into shareholder distributions and selective acquisitions. Operating working capital expanded to \$2,374.3 million at June 30, 2026, including \$63.8 million from the newly acquired Jackson Supply business. Total shareholders' equity stood at \$3,473.2 million, including \$478.8 million in non-controlling interests from the Carrier joint ventures.

Revenue | Quarterly | USD billions



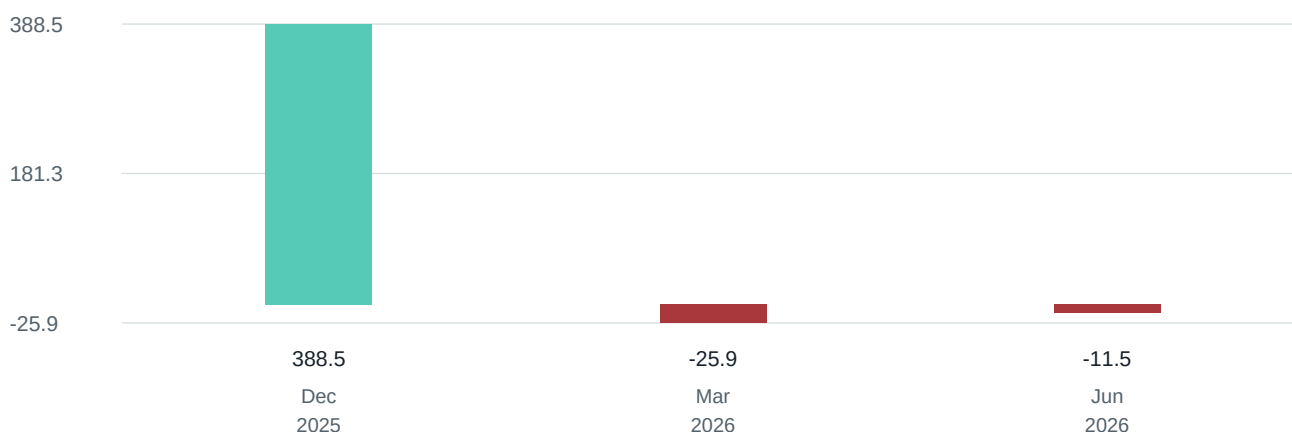
Showing 3 available quarterly periods, up to the latest 15. Period ends are shown below each value. Normalized reported values, not forecasts. Latest retained filing at the evidence cutoff; unavailable or conflicting values remain gaps.

Operating margin | Quarterly | %



Showing 3 available quarterly periods, up to the latest 15. Period ends are shown below each value. Operating income / revenue. Zero or unavailable revenue has no margin. Latest retained filing at the evidence cutoff; gaps are not zero.

Free cash flow | Quarterly | USD millions



Showing 3 available quarterly periods, up to the latest 15. Period ends are shown below each value. Normalized reported values, not forecasts. Latest retained filing at the evidence cutoff; unavailable or conflicting values remain gaps.

Valuation: bear, base and bull cases

We evaluate Watsco over an approximate 18-month horizon to March 31, 2028, starting from a reference closing price of \$297.5 on October 2, 2026. At this level, Watsco trades at 21.4 times our normalized pro forma base earnings power of \$13.90 per share and 25.5 times depressed trailing earnings of \$11.67 per share. These valuation levels sit comfortably below Watsco's five-year historical median price-to-earnings multiple of 27.7 times.

Our Base Case scenario establishes a target price of \$385.0 per share, delivering an expected price return of 29.4% (18.7% annualized). This assumes gross margins normalize to a through-cycle 28.2%, domestic residential replacement volumes expand by 2.0%, Jackson Supply (\$230.0 million sales) and Granite Group (\$500.0 million sales) integrate smoothly, and normalized pro forma diluted earnings reach \$13.90, valued at Watsco's historical median multiple of 27.7 times.

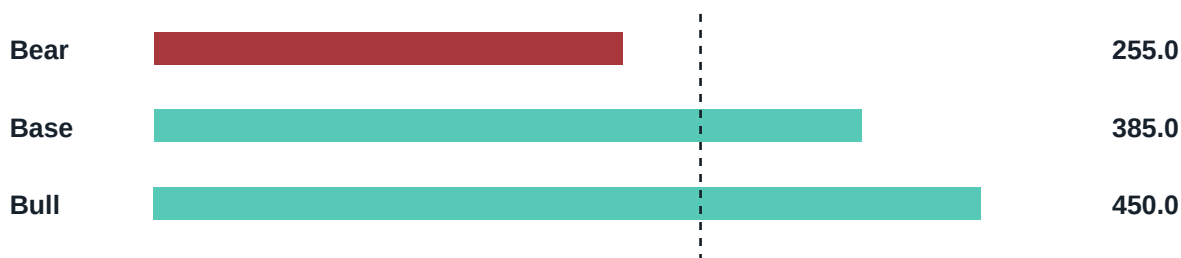
Our Bear Case scenario models a downside price of \$255.0 per share, representing a price decline of 14.3%. This assumes persistent wholesale pricing friction holds gross margins at 27.0%, commercial HVAC sales continue contracting at 8.0%, residential replacement demand softens, Granite Group integration delays push financial accretion into 2028, and the valuation multiple de-rates to a cyclical trough of 21.5 times on reduced earnings of \$11.85 per share.

Our Bull Case scenario projects an upside price of \$450.0 per share (+51.3% price return). This scenario incorporates faster consumer adoption of premium A2L and heat pump units (+4.0% average selling prices and +3.0% volume growth), gross margin expansion to 28.6%, rapid synergy realization across the Granite network, and earnings reaching \$15.00 per share valued at a premium 30.0 times multiple.

On a probability-weighted basis (20.0% Bear, 60.0% Base, and 20.0% Bull), the expected price target is \$372.0 per share, generating an annualized return of 16.0%. The risk-reward asymmetry ratio stands at 2.1 times (29.4% base upside versus 14.3% bear downside), providing strong protection against downside impairment. In addition, Watsco's quarterly dividend of \$3.30 per share provides a current dividend yield of 4.4% at the reference price.

Scenario price comparison

USD per share. Reference price 297.5 on 2 October 2026. Scenario horizon: 31 March 2028. Estimates, not guaranteed outcomes.



Dashed line: dated reference price. Scenarios are model assumptions, not historical observations.

Bear: Gross margins remain compressed at 27.0%, residential replacement demand softens, Granite Group integration delayed, multiple compresses to 21.5x on \$11.85 trough EPS.

Base: Gross margins stabilize at through-cycle 28.2%, domestic residential unit volumes grow 2%, Jackson and Granite contribute \$730M revenue, normalized EPS of \$13.90 valued at 27.7x historical median multiple.

Bull: Accelerated A2L/heat-pump adoption lifts ASP by 4% with 3% unit growth, gross margin recovers to 28.6%, full Granite Group synergies realized, EPS reaches \$15.00 valued at premium 30.0x multiple.

The case for potential S&P 500 outperformance

We believe Watsco offers superior capital appreciation potential relative to the S&P 500 price index over the next 12 to 24 months. Our base case price target of \$385.0 translates to an 18.7% annualized price return from the October 2, 2026 close of \$297.5, compared to broader market equity hurdle rates of roughly 8.5%. This price outperformance is driven by specific operating and regulatory inflections rather than broader macroeconomic expansion.

The primary operational driver is the normalization of wholesale gross margins. Every 50 basis point restoration in gross margin generates approximately \$36.4 million in operating profit on Watsco's standalone revenue base. As contract prices catch up to stable manufacturer list prices, earnings growth will accelerate sharply off the second-quarter 2026 trough, defying consensus expectations of prolonged margin stagnation.

The second key driver is revenue and profit accretion from M&A consolidation. Combining Jackson Supply (\$230.0 million annual sales) and Granite Group (\$500.0 million annual sales) adds approximately \$730.0 million in profitable wholesale distribution volume. Because Watsco funds these transactions primarily through cash reserves and low-cost credit facility capacity rather than dilutive equity issuances, pro forma earnings per share should benefit by \$0.45 to \$0.60 annually once integration is completed.

Catalysts over the next 12-24 months

The first major catalyst is regulatory clarity under the EPA's American Innovation and Manufacturing Act. The EPA's final rule issued on May 26, 2026 eliminated the year-end installation deadline for matching R-410A systems effective July 26, 2026. This allows contractors to freely install existing matching systems throughout 2026 and 2027, unlocking previously delayed replacement projects and eliminating inventory markdown risks across Watsco's \$1,890.5 million inventory base.

The second catalyst is the seasonal release of working capital in the second half of 2026. As summer receivables and inventory liquidate, operating cash flow typically rebounds by more than \$400.0 million across the third and fourth quarters, mirroring the \$569.6 million full-year operating cash flow achieved in 2025. This cash influx will alleviate investor concerns regarding dividend coverage and preserve cash liquidity.

The third catalyst is the closing and initial contribution of the Granite Group Holdings merger, anticipated in late 2026 or early 2027 following antitrust review under the Hart-Scott-Rodino Act. Adding 82 branch locations across seven Northeast states significantly deepens Watsco's presence in plumbing and heating supplies, generating visible top-line momentum in early 2027 financial reports.

No sufficiently dated event series was available for a timeline. See the catalysts and risks discussed in the report.

Risks and contrary evidence

The strongest bear argument contends that Watsco's wholesale gross margins may remain trapped below 27.5% due to contractor resistance and end-consumer affordability pressures. In the second quarter of 2026, gross margin declined 180 basis points to 27.5%, and commercial HVAC sales contracted by 8.0%. If OEM cost inflation cannot be passed along and non-residential weakness spills into residential markets, earnings would fail to recover toward our base projection.

A second major risk is supplier concentration. Purchases from Carrier Global Corporation represented 62.0% of inventory purchases in 2025 and 64.0% in the second quarter of 2026, while Carrier joint ventures represented 53.0% of consolidated revenues. Any commercial dispute, supply disruption, or unfavorable renegotiation of distribution territories with Carrier would directly harm financial performance.

A third risk involves capital allocation stress. Paying an annualized common dividend of \$13.20 per share requires roughly \$504.1 million in cash annually. In the first half of 2026, common dividends consumed \$255.9 million against negative operating cash flow of -\$21.4 million. Closing the Granite Group merger requires an additional \$404.0 million in cash. Funding this acquisition will likely require drawing \$200.0 million to \$250.0 million on the credit facility, shifting net interest from \$10.0 million in income to modest interest expense.

In a modeled severe stress scenario featuring a 20.0% volume contraction and a 200 basis point margin decline, counter-cyclical working capital release (+ \$160.0 million) and zero funded debt keep peak revolver borrowings below \$350.0 million. This leaves covenant leverage at 0.58 times, well inside the credit facility ceiling of 3.25 times, and preserves more than \$385.0 million in liquid buffer.

What remains uncertain

Several material uncertainties require ongoing monitoring. First, the Granite Group Holdings acquisition is subject to customary closing conditions, including antitrust review under the Hart-Scott-Rodino Act and final post-closing purchase price adjustments. While structured as an 80% cash and 20% equity transaction, the exact closing date and final borrowing draw remain pending.

Second, Watsco is currently engaged in litigation in Florida Circuit Court with Gree Electric Appliances regarding whether their distribution agreement automatically renewed for a 10-year term through 2036. Although Gree-branded products accounted for less than 3.0% of consolidated revenues over the twelve months ended June 30, 2026, an adverse judicial determination would require replacing those product volumes with alternative ductless brands.

Third, the macroeconomic impact of trade policy and tax credit changes remains evolving. While Section 232 derivative tariffs on residential HVAC components were adjusted downward from 25.0% to 15.0% in June 2026, OEM production in Mexico remains exposed to trade actions. Concurrently, the elimination of federal Inflation Reduction Act energy-efficiency tax credits after December 31, 2025 (under the One Big Beautiful Bill) creates some uncertainty regarding consumer appetite for premium high-efficiency heat pumps.

What would invalidate our thesis

We have established specific, observable conditions that would invalidate our investment thesis and require downgrading our outlook. The primary operational falsifier is gross margin performance: if consolidated gross margin fails to exceed 27.2% across the third and fourth quarters of 2026, or falls below 27.0%, it would indicate structural inability to pass through product costs.

The second falsifier is cash conversion: if full-year 2026 operating cash flow fails to reach \$300.0 million, it would disprove our expectation of seasonal working capital liquidation and demonstrate structural cash absorption, directly threatening dividend coverage.

Additional falsification milestones include a greater than 5.0% year-over-year contraction in domestic residential replacement unit volumes during the second half of 2026, any inventory obsolescence write-down exceeding \$15.0 million on legacy R-410A equipment, or an antitrust block or termination of the Granite Group merger agreement.

Methodology note

We use our proprietary Eaglewing Research System (EWRS) to assess evidence, valuation, risks and contrary views. We develop and cross-check our investment thesis and research report, weighing the supporting evidence against risks, alternative explanations and valuation assumptions.

Important disclaimer

Research and informational purposes only, not investment advice. Valuation scenarios are assumptions, not promises. Outperformance is not guaranteed; an investment may lose value. The S&P 500 comparison uses price returns and excludes dividends, fees and taxes.

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