
**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, 2020**

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.)

**675 Bering Drive
Suite 400**

Houston, Texas 77057

(Address of Principal Executive Offices) (Zip Code)

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, \$0.01 par value	FIX	New York Stock Exchange

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes No

The number of shares outstanding of the issuer's common stock as of October 21, 2020 was 36,394,751 (excluding treasury shares of 4,728,614).

COMFORT SYSTEMS USA, INC.
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PART I—FINANCIAL INFORMATION

Item 1. Financial Statements

COMFORT SYSTEMS USA, INC.
CONSOLIDATED BALANCE SHEETS
(In Thousands, Except Share Amounts)

	September 30, 2020 (Unaudited)	December 31, 2019
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 70,540	\$ 50,788
Billed accounts receivable, less allowance for credit losses of \$9,896 and \$6,907, respectively	608,861	619,037
Unbilled accounts receivable, less allowance for credit losses of \$784 and \$0, respectively	46,509	55,542
Other receivables, less allowance for credit losses of \$884 and \$0, respectively	36,991	37,632
Inventories	12,700	10,053
Prepaid expenses and other	10,313	14,396
Costs and estimated earnings in excess of billings, less allowance for credit losses of \$79 and \$0, respectively	25,382	2,736
Total current assets	811,296	790,184
PROPERTY AND EQUIPMENT, NET	119,131	109,796
LEASE RIGHT-OF-USE ASSET	95,815	84,073
GOODWILL	420,782	332,447
IDENTIFIABLE INTANGIBLE ASSETS, NET	201,998	159,974
DEFERRED TAX ASSETS	21,656	21,923
OTHER NONCURRENT ASSETS	7,291	6,615
Total assets	<u>\$ 1,677,969</u>	<u>\$ 1,505,012</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Current maturities of long-term debt	\$ 70	\$ 20,817
Accounts payable	176,484	196,195
Accrued compensation and benefits	119,931	102,891
Billings in excess of costs and estimated earnings	217,454	166,918
Accrued self-insurance	49,369	39,546
Other current liabilities	92,035	81,630
Total current liabilities	655,343	607,997
LONG-TERM DEBT, NET	222,213	205,318
LEASE LIABILITIES	81,638	72,697
DEFERRED TAX LIABILITIES	3,365	1,425
OTHER LONG-TERM LIABILITIES	47,284	32,271
Total liabilities	1,009,843	919,708
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, 41,123,365 and 41,123,365 shares issued, respectively	411	411
Treasury stock, at cost, 4,723,672 and 4,465,448 shares, respectively	(118,551)	(103,960)
Additional paid-in capital	322,304	320,168
Retained earnings	463,962	368,685
Total stockholders' equity	668,126	585,304
Total liabilities and stockholders' equity	<u>\$ 1,677,969</u>	<u>\$ 1,505,012</u>

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,	
	2020	2019	2020	2019
REVENUE	\$ 714,099	\$ 706,918	\$ 2,157,698	\$ 1,895,693
COST OF SERVICES	566,903	564,216	1,747,714	1,526,310
Gross profit	147,196	142,702	409,984	369,383
SELLING, GENERAL AND ADMINISTRATIVE EXPENSES	90,888	90,006	268,857	253,417
GAIN ON SALE OF ASSETS	(377)	(708)	(1,243)	(1,119)
Operating income	56,685	53,404	142,370	117,085
OTHER INCOME (EXPENSE):				
Interest income	7	82	99	174
Interest expense	(1,733)	(2,779)	(6,904)	(6,891)
Changes in the fair value of contingent earn-out obligations	3,423	(2,004)	1,824	(3,924)
Other	(15)	3	10	167
Other income (expense)	1,682	(4,698)	(4,971)	(10,474)
INCOME BEFORE INCOME TAXES	58,367	48,706	137,399	106,611
PROVISION FOR INCOME TAXES	8,279	12,473	30,100	26,339
NET INCOME	<u>\$ 50,088</u>	<u>\$ 36,233</u>	<u>\$ 107,299</u>	<u>\$ 80,272</u>
INCOME PER SHARE:				
Basic	<u>\$ 1.37</u>	<u>\$ 0.98</u>	<u>\$ 2.93</u>	<u>\$ 2.18</u>
Diluted	<u>\$ 1.36</u>	<u>\$ 0.98</u>	<u>\$ 2.92</u>	<u>\$ 2.16</u>
SHARES USED IN COMPUTING INCOME PER SHARE:				
Basic	<u>36,557</u>	<u>36,805</u>	<u>36,604</u>	<u>36,891</u>
Diluted	<u>36,750</u>	<u>37,051</u>	<u>36,797</u>	<u>37,170</u>
DIVIDENDS PER SHARE	<u>\$ 0.105</u>	<u>\$ 0.100</u>	<u>\$ 0.314</u>	<u>\$ 0.295</u>

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)

(Unaudited)

	Nine Months Ended September 30, 2019						
	Common Stock		Treasury Stock		Additional Paid-In Capital	Retained Earnings	Total Stockholders' Equity
	Shares	Amount	Shares	Amount			
BALANCE AT DECEMBER 31, 2018	41,123,365	\$ 411	(4,229,653)	\$ (87,747)	\$ 316,479	\$ 268,904	\$ 498,047
Net income	—	—	—	—	—	19,866	19,866
Issuance of Stock:							
Issuance of shares for options exercised	—	—	41,103	861	(61)	—	800
Issuance of restricted stock & performance stock	—	—	38,539	817	1,189	—	2,006
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	(15,013)	(781)	—	—	(781)
Stock-based compensation	—	—	—	—	2,084	—	2,084
Dividends	—	—	—	—	—	(3,506)	(3,506)
Share repurchase	—	—	(67,394)	(3,321)	—	—	(3,321)
BALANCE AT MARCH 31, 2019	41,123,365	411	(4,232,418)	(90,171)	319,691	285,264	515,195
Net income	—	—	—	—	—	24,173	24,173
Issuance of Stock:							
Issuance of shares for options exercised	—	—	1,408	31	(11)	—	20
Issuance of restricted stock & performance stock	—	—	69,067	1,486	(1,486)	—	—
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	(13,573)	(717)	—	—	(717)
Stock-based compensation	—	—	—	—	1,685	—	1,685
Dividends	—	—	—	—	—	(3,692)	(3,692)
Share repurchase	—	—	(93,468)	(4,576)	—	—	(4,576)
BALANCE AT JUNE 30, 2019	41,123,365	411	(4,268,984)	(93,947)	319,879	305,745	532,088
Net income	—	—	—	—	—	36,233	36,233
Issuance of Stock:							
Issuance of shares for options exercised	—	—	5,426	124	57	—	181
Issuance of restricted stock & performance stock	—	—	—	—	—	—	—
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	—	—	—	—	—
Stock-based compensation	—	—	—	—	221	—	221
Dividends	—	—	—	—	—	(3,673)	(3,673)
Share repurchase	—	—	(183,880)	(7,420)	—	—	(7,420)
BALANCE AT SEPTEMBER 30, 2019	41,123,365	\$ 411	(4,447,438)	\$ (101,243)	\$ 320,157	\$ 338,305	\$ 557,630

COMFORT SYSTEMS USA, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In Thousands, Except Share Amounts)
(Unaudited)

	Nine Months Ended September 30, 2020						Total Stockholders' Equity
	Common Stock		Treasury Stock		Additional Paid-In Capital	Retained Earnings	
	Shares	Amount	Shares	Amount			
BALANCE AT DECEMBER 31, 2019	41,123,365	\$ 411	(4,465,448)	\$ (103,960)	\$ 320,168	\$ 368,685	\$ 585,304
Net income	—	—	—	—	—	17,716	17,716
Cumulative-effect adjustment (1)	—	—	—	—	—	(515)	(515)
Issuance of Stock:							
Issuance of shares for options exercised	—	—	—	—	—	—	—
Issuance of restricted stock & performance stock	—	—	43,902	1,054	801	—	1,855
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	(14,722)	(622)	—	—	(622)
Stock-based compensation	—	—	—	—	2,134	—	2,134
Dividends	—	—	—	—	—	(3,844)	(3,844)
Share repurchase	—	—	(237,359)	(8,985)	—	—	(8,985)
BALANCE AT MARCH 31, 2020	41,123,365	411	(4,673,627)	(112,513)	323,103	382,042	593,043
Net income	—	—	—	—	—	39,495	39,495
Issuance of Stock:							
Issuance of shares for options exercised	—	—	34,562	836	(280)	—	556
Issuance of restricted stock & performance stock	—	—	84,987	2,048	(2,048)	—	—
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	(13,002)	(454)	—	—	(454)
Stock-based compensation	—	—	—	—	1,644	—	1,644
Dividends	—	—	—	—	—	(3,830)	(3,830)
Share repurchase	—	—	(52,991)	(2,021)	—	—	(2,021)
BALANCE AT JUNE 30, 2020	41,123,365	411	(4,620,071)	(112,104)	322,419	417,707	628,433
Net income	—	—	—	—	—	50,088	50,088
Issuance of Stock:							
Issuance of shares for options exercised	—	—	54,207	1,324	(325)	—	999
Issuance of restricted stock & performance stock	—	—	—	—	—	—	—
Shares received in lieu of tax withholding payment on vested restricted stock	—	—	—	—	—	—	—
Stock-based compensation	—	—	—	—	210	—	210
Dividends	—	—	—	—	—	(3,833)	(3,833)
Share repurchase	—	—	(157,808)	(7,771)	—	—	(7,771)
BALANCE AT SEPTEMBER 30, 2020	<u>41,123,365</u>	<u>\$ 411</u>	<u>(4,723,672)</u>	<u>\$ (118,551)</u>	<u>\$ 322,304</u>	<u>\$ 463,962</u>	<u>\$ 668,126</u>

(1) Represents the adjustment to Retained Earnings as a result of adopting Accounting Standards Update (ASU) No. 2016-13, "Financial Instruments – Credit Losses (Topic 326)," on January 1, 2020. See Note 2 for more information.

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,	
	2020	2019
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 107,299	\$ 80,272
Adjustments to reconcile net income to net cash provided by operating activities—		
Amortization of identifiable intangible assets	25,306	20,221
Depreciation expense	20,818	18,222
Change in right-of-use assets	12,338	10,552
Bad debt expense	5,318	2,093
Deferred tax provision (benefit)	1,197	(2,620)
Amortization of debt financing costs	408	287
Gain on sale of assets	(1,243)	(1,119)
Changes in the fair value of contingent earn-out obligations	(1,824)	3,924
Stock-based compensation	5,949	4,861
Changes in operating assets and liabilities, net of effects of acquisitions and divestitures—		
(Increase) decrease in—		
Receivables, net	33,304	(31,647)
Inventories	(708)	(248)
Prepaid expenses and other current assets	9,417	(4,625)
Costs and estimated earnings in excess of billings and unbilled accounts receivable	(7,007)	(2,081)
Other noncurrent assets	(631)	(544)
Increase (decrease) in—		
Accounts payable and accrued liabilities	(16,030)	6,635
Billings in excess of costs and estimated earnings	13,489	4,555
Other long-term liabilities	9,000	(9,023)
Net cash provided by operating activities	<u>216,400</u>	<u>99,715</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of property and equipment	(19,459)	(22,641)
Proceeds from sales of property and equipment	1,890	1,447
Proceeds from sale of business	—	1,611
Cash paid for acquisitions, net of cash acquired	(112,945)	(196,470)
Net cash used in investing activities	<u>(130,514)</u>	<u>(216,053)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from revolving credit facility	198,000	320,000
Payments on revolving credit facility	(164,500)	(177,000)
Payments on term loan	(15,000)	—
Payments on other debt	(44,464)	(3,254)
Payments of dividends to stockholders	(11,507)	(10,871)
Share repurchase	(18,777)	(15,317)
Shares received in lieu of tax withholding	(1,076)	(1,498)
Proceeds from exercise of options	1,555	1,001
Deferred acquisition payments	(500)	(637)
Payments for contingent consideration arrangements	(9,865)	(1,343)
Net cash provided by (used in) financing activities	<u>(66,134)</u>	<u>111,081</u>
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	<u>19,752</u>	<u>(5,257)</u>
CASH AND CASH EQUIVALENTS, beginning of period	50,788	45,620
CASH AND CASH EQUIVALENTS, end of period	<u>\$ 70,540</u>	<u>\$ 40,363</u>

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

COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

September 30, 2020

(Unaudited)

1. Business and Organization

Comfort Systems USA, Inc., a Delaware corporation, provides comprehensive mechanical and electrical contracting services, which principally includes heating, ventilation and air conditioning (“HVAC”), plumbing, electrical, piping and controls, as well as off-site construction, monitoring and fire protection. We install, maintain, repair and replace products and systems throughout the United States. The terms “Comfort Systems,” “we,” “us,” or the “Company,” refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

2. Summary of Significant Accounting Policies

Basis of Presentation

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission (“SEC”) for the year ended December 31, 2019 (the “Form 10-K”).

The accompanying unaudited consolidated financial statements were prepared using generally accepted accounting principles for interim financial information and the instructions to Form 10-Q and applicable rules of Regulation S-X of the SEC. Accordingly, these financial statements do not include all the footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the Form 10-K. We believe all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for interim periods are not necessarily indicative of the results for the full fiscal year.

Use of Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires the use of estimates and assumptions by management in determining the reported amounts of assets and liabilities, revenue and expenses and disclosures regarding contingent assets and liabilities. Actual results could differ from those estimates. The most significant estimates used in our financial statements affect revenue and cost recognition for construction contracts, the allowance for credit losses, self-insurance accruals, deferred tax assets, fair value accounting for acquisitions and the quantification of fair value for reporting units in connection with our goodwill impairment testing.

Recent Accounting Pronouncements

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326).” The standard requires companies to consider historical experiences, current market conditions and reasonable and supportable forecasts in the measurement of expected credit losses. The standard requires us to accrue higher credit losses on financial assets compared to the legacy guidance on various items, such as contract assets and current receivables. ASU No. 2016-13 is effective for fiscal years beginning after December 15, 2019 and interim periods within those years. We adopted ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326),” on January 1, 2020, and the impact was not material to our overall financial statements. The adoption of ASU No. 2016-13 resulted in an increase in Allowance for Credit Losses of \$0.7 million, an increase to Deferred Tax Assets of \$0.2 million and an impact of \$0.5 million to Retained Earnings.

In August 2018, the FASB issued ASU No. 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement.” This standard removes certain

disclosure requirements, including the valuation processes for Level 3 fair value measurements, the policy for timing of transfers between levels and the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy. The standard requires certain additional disclosures for public entities, including disclosure of the changes in unrealized gains and losses included in Other Comprehensive Income for Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. ASU No. 2018-13 is effective for fiscal years beginning after December 15, 2019 and interim periods within those years. Certain amendments, including the amendment on changes in unrealized gains and losses and the range and weighted average of significant unobservable inputs, should be applied prospectively while other amendments should be applied retrospectively to all periods presented upon their effective date. We have modified our fair value disclosures to conform with the requirements of ASU No. 2018-13, “Fair Value Measurement (Topic 820): Disclosure Framework — Changes to the Disclosure Requirements for Fair Value Measurement,” which we adopted on January 1, 2020.

In December 2019, the FASB issued ASU No. 2019-12, “Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes.” This standard simplifies the accounting for income taxes by eliminating certain exceptions to the guidance in Topic 740 related to the approach for intraperiod tax allocation, the methodology for calculating income taxes in an interim period and the recognition of deferred tax liabilities for outside basis differences. The standard also simplifies aspects of the accounting for franchise taxes and enacted changes in tax laws or rates and clarifies the accounting for transactions that result in a step-up in the tax basis of goodwill. ASU No. 2019-12 is effective for fiscal years beginning after December 15, 2020 and interim periods within that year. Early adoption is permitted. We do not expect our adoption of this standard on January 1, 2021 to have a material impact on our consolidated financial statements.

In May 2020, the SEC issued a final rule to amend the financial statement requirements for business combinations and dispositions, including the related pro forma financial information. The rule revises the significance tests, including consideration of registrant’s market capitalization for the investment test and consideration of registrant’s revenue for the income test. The significance threshold for business dispositions is also increased from 10% to 20%. The rule further eliminates the potential requirement that registrants present a third year of audited financial statements of acquired businesses and modifies pro forma adjustments rules for items directly related to accounting for the transaction. The rule is effective January 1, 2021. Early adoption is permitted. The impact of this authoritative guidance on our consolidated financial statements will depend on future acquisitions and dispositions completed subsequent to adoption of this guidance.

Revenue Recognition

Revenue is recognized when control of the promised goods or services is transferred to our customers, in an amount that reflects the consideration to which we expect to be entitled in exchange for those goods or services. Sales-based taxes are excluded from revenue.

We provide mechanical and electrical contracting services. Our mechanical segment principally includes HVAC, plumbing, piping and controls, as well as off-site construction, monitoring and fire protection. Our electrical segment includes installation and servicing of electrical systems. We install, maintain, repair and replace products and systems throughout the United States. All of our revenue is recognized over time as we deliver goods and services to our customers. Revenue can be earned based on an agreed-upon fixed price or based on actual costs incurred, marked up at an agreed-upon percentage.

We account for a contract when: (i) it has approval and commitment from both parties, (ii) the rights of the parties are identified, (iii) payment terms are identified, (iv) the contract has commercial substance, and (v) collectability of consideration is probable. We consider the start of a project to be when the above criteria have been met and we either have written authorization from the customer to proceed or an executed contract.

We generally do not incur significant incremental costs related to obtaining or fulfilling a contract prior to the start of a project. On rare occasions, when significant pre-contract costs are incurred, they are capitalized and amortized on a percentage of completion basis over the life of the contract. We do not currently have any capitalized obtainment or fulfillment costs on our Balance Sheet and did not incur any impairment loss on such costs in the current year.

Due to the nature of the work required to be performed on many of our performance obligations, the estimation of total revenue and cost at completion (the process described below in more detail) is complex, subject to many variables and requires significant judgment. The consideration to which we are entitled on our long-term contracts may include both fixed and variable amounts. Variable amounts can either increase or decrease the transaction price. A common example of variable amounts that can either increase or decrease contract value are pending change orders that represent contract modifications for which a change in scope has been authorized or acknowledged by our customer, but the final adjustment to contract price is yet to be negotiated. Other examples of positive variable revenue include amounts awarded upon achievement of certain performance metrics, program milestones or cost of completion date targets and can be based upon customer discretion. Variable amounts can result in a deduction from contract revenue if we fail to meet stated performance requirements, such as complying with the construction schedule.

Contracts are often modified to account for changes in contract specifications and requirements. We consider contract modifications to exist when the modification either creates new, or changes the existing, enforceable rights and obligations. Most of our contract modifications are for goods or services that are not distinct from the existing performance obligation(s). The effect of a contract modification on the transaction price, and our measure of progress for the performance obligation to which it relates, is recognized as an adjustment to revenue (either as an increase or decrease) on a cumulative catchup basis.

We have a Company-wide policy requiring periodic review of the Estimate at Completion in which management reviews the progress and execution of our performance obligations and estimated remaining obligations. As part of this process, management reviews information including, but not limited to, any outstanding key contract matters, progress towards completion and the related program schedule, identified risks and opportunities and the related changes in estimates of revenue and costs. The risks and opportunities include management's judgment about the ability and cost to achieve the schedule (e.g., the number and type of milestone events), technical requirements (e.g., a newly developed product versus a mature product) and other contract requirements. Management must make assumptions and estimates regarding labor productivity and availability, the complexity of the work to be performed, the availability of materials, the length of time to complete the performance obligation (e.g., to estimate increases in wages and prices for materials and related support cost allocations), execution by our subcontractors, the availability and timing of funding from our customer, and overhead cost rates, among other variables.

Based on this analysis, any adjustments to revenue, cost of services, and the related impact to operating income are recognized as necessary in the quarter when they become known. These adjustments may result from positive program performance if we determine we will be successful in mitigating risks surrounding the technical, schedule and cost aspects of those performance obligations or realizing related opportunities and may result in an increase in operating income during the performance of individual performance obligations. Likewise, if we determine we will not be successful in mitigating these risks or realizing related opportunities, these adjustments may result in a decrease in operating income. Changes in estimates of revenue, cost of services and the related impact to operating income are recognized quarterly on a cumulative catchup basis, meaning we recognize in the current period the cumulative effect of the changes on current and prior periods based on a performance obligation's percentage of completion. A significant change in one or more of these estimates could affect the profitability of one or more of our performance obligations. For projects in which estimates of total costs to be incurred on a performance obligation exceed total estimates of revenue to be earned, a provision for the entire loss on the performance obligation is recognized in the period the loss is determined.

In the first nine months of 2020 and 2019, net revenue recognized from our performance obligations satisfied in previous periods was not material.

Disaggregation of Revenue

Our consolidated 2020 revenue was derived from contracts to provide service activities in the mechanical and electrical services segments we serve. Refer to Note 9 – Segment Information for additional information on our reportable segments. We disaggregate our revenue from contracts with customers by activity, customer type and service provided, as we believe it best depicts how the nature, amount, timing and uncertainty of our revenue and cash flows are affected by economic factors. See details in the following tables (dollars in thousands):

Revenue by Service Provided	Three Months Ended September 30,				Nine Months Ended September 30,			
	2020		2019		2020		2019	
Mechanical Services	\$ 621,140	87.0 %	\$ 590,016	83.5 %	\$ 1,809,304	83.9 %	\$ 1,677,632	88.5 %
Electrical Services	92,959	13.0 %	116,902	16.5 %	348,394	16.1 %	218,061	11.5 %
Total	\$ 714,099	100.0 %	\$ 706,918	100.0 %	\$ 2,157,698	100.0 %	\$ 1,895,693	100.0 %

Revenue by Type of Customer	Three Months Ended September 30,				Nine Months Ended September 30,			
	2020		2019		2020		2019	
Industrial	\$ 268,651	37.6 %	\$ 222,156	31.4 %	\$ 844,719	39.1 %	\$ 588,818	31.1 %
Education	135,992	19.0 %	125,836	17.8 %	375,580	17.4 %	292,799	15.4 %
Office Buildings	81,183	11.4 %	83,271	11.8 %	232,349	10.8 %	254,966	13.5 %
Healthcare	86,061	12.1 %	126,909	18.0 %	281,370	13.0 %	306,810	16.2 %
Government	40,631	5.7 %	41,502	5.9 %	119,444	5.5 %	118,224	6.2 %
Retail, Restaurants and Entertainment	64,212	9.0 %	67,141	9.5 %	190,043	8.8 %	184,618	9.7 %
Multi-Family and Residential	21,776	3.0 %	24,121	3.4 %	61,062	2.8 %	83,417	4.4 %
Other	15,593	2.2 %	15,982	2.2 %	53,131	2.6 %	66,041	3.5 %
Total	\$ 714,099	100.0 %	\$ 706,918	100.0 %	\$ 2,157,698	100.0 %	\$ 1,895,693	100.0 %

Revenue by Activity Type	Three Months Ended September 30,				Nine Months Ended September 30,			
	2020		2019		2020		2019	
New Construction	\$ 310,000	43.4 %	\$ 312,279	44.2 %	\$ 1,034,833	48.0 %	\$ 827,718	43.7 %
Existing Building Construction	235,798	33.0 %	224,125	31.6 %	668,067	30.9 %	605,819	31.9 %
Service Projects	69,162	9.7 %	62,668	8.9 %	179,188	8.3 %	171,860	9.1 %
Service Calls, Maintenance and Monitoring	99,139	13.9 %	107,846	15.3 %	275,610	12.8 %	290,296	15.3 %
Total	\$ 714,099	100.0 %	\$ 706,918	100.0 %	\$ 2,157,698	100.0 %	\$ 1,895,693	100.0 %

Allowance for Credit Losses

We are required to estimate and record the expected credit losses over the contractual life of our financial assets measured at amortized cost, including billed and unbilled accounts receivable, other receivables and costs and estimated earnings in excess of billings. Accounts receivable include amounts from work completed in which we have billed or have an unconditional right to bill our customers. Our trade receivables are contractually due in less than a year.

We estimate our credit losses using a loss-rate method for each of our identified portfolio segments. Our portfolio segments are construction, service and other. While our construction and service financial assets are often with the same subset of customers and industries, our construction financial assets will generally have a lower loss-rate than service financial assets due to lien rights, which we are more likely to have on construction jobs. These lien rights result in lower credit loss expenses on average compared to receivables that do not have lien rights. Financial assets classified as Other include receivables that are not related to our core revenue producing activities, such as receivables related to our acquisition activity from former owners, our vendor rebate program or receivables for estimated losses in excess of our insurance deductible, which are accrued with a corresponding accrued insurance liability.

Loss rates for our portfolios are based on numerous factors, including our history of credit loss expense by portfolio, the financial strength of our customers and counterparties in each portfolio, the aging of our receivables, our expectation of likelihood of payment, macroeconomic trends in the U.S. and the current and forecasted non-residential construction market trends in the U.S.

In addition to the loss-rate calculations discussed above, we also record allowance for credit losses for specific receivables that are deemed to have a higher risk profile than the rest of the respective pool of receivables, such as concerns about a specific customer going bankrupt and no longer being able to pay the receivables due to us.

Starting in March 2020, we experienced negative impacts to our business due to the business disruption caused by Coronavirus Disease 2019 (“COVID-19”). In March 2020, the World Health Organization categorized COVID-19 as

a pandemic, and the President of the United States declared the COVID-19 outbreak a national emergency. The Company considered the impact of COVID-19 on the assumptions and estimates used to determine the results reported and asset valuations as of September 30, 2020.

During the first nine months of 2020, we increased our loss rates and increased our specific reserves primarily due to the economic disruption caused by COVID-19, which is reflected in our bad debt expense in the current year. This increase was primarily, but not exclusively, due to concern over collectability of receivables from customers more directly impacted by COVID-19.

Activity in our allowance for credit losses consisted of the following (in thousands):

	Service	Construction	Other	Total
Balance at beginning of year	\$ 3,192	\$ 3,400	\$ 315	\$ 6,907
Impact of new accounting standard	310	331	54	695
Bad debt expense (benefit)	2,651	2,678	(11)	5,318
Deductions for uncollectible receivables written off, net of recoveries	(913)	(623)	—	(1,536)
Credit allowance of acquired companies on the acquisition date	—	502	—	502
Purchase accounting adjustments	—	72	—	72
Reclass to other current liabilities	—	—	(315)	(315)
Balance at September 30, 2020	<u>\$ 5,240</u>	<u>\$ 6,360</u>	<u>\$ 43</u>	<u>\$ 11,643</u>

Contract Assets and Liabilities

Project contracts typically provide for a schedule of billings or invoices to the customer based on our job-to-date percentage of completion of specific tasks inherent in the fulfillment of our performance obligation(s). The schedules for such billings usually do not precisely match the schedule on which costs are incurred. Contract assets include unbilled amounts typically resulting from sales under long term contracts when the cost to cost method of revenue recognition is used, revenue recognized exceeds the amount billed to the customer and right to payment is conditional or subject to completing a milestone, such as a phase of the project. Contract assets are generally classified as current.

Contract liabilities consist of advance payments and billings in excess of revenue recognized. Our contract assets and liabilities are reported in a net position on a contract by contract basis at the end of each reporting period. We classify advance payments and billings in excess of revenue recognized as current. It is very unusual for us to have advanced payments with a term of greater than one year; therefore, our contract assets and liabilities are usually all current. If we have advanced payments with a term greater than one year, the noncurrent portion of advanced payments would be included in other long-term liabilities in our consolidated Balance Sheets.

The following table presents the changes in contract assets and contract liabilities (in thousands):

	Nine Months Ended September 30,		Year Ended December 31,	
	2020		2019	
	Contract Assets	Contract Liabilities	Contract Assets	Contract Liabilities
Balance at beginning of period	\$ 2,736	\$ 166,918	\$ 10,213	\$ 130,986
Change due to acquisitions / disposals	7,469	37,047	6,573	31,556
Change related to credit allowance	(79)	—	—	—
Other changes in the period	15,256	13,489	(14,050)	4,376
Balance at end of period	<u>\$ 25,382</u>	<u>\$ 217,454</u>	<u>\$ 2,736</u>	<u>\$ 166,918</u>

In the first nine months of 2020 and 2019, we recognized revenue of \$164.4 million and \$123.3 million related to our contract liabilities at January 1, 2020 and January 1, 2019, respectively.

We did not have any impairment losses recognized on our receivables or contract assets in the first nine months of 2020 and 2019.

Remaining Performance Obligations

Remaining construction performance obligations represent the remaining transaction price of firm orders for which work has not been performed and exclude unexercised contract options. As of September 30, 2020, the aggregate amount of the transaction price allocated to remaining performance obligations was \$1.43 billion. The Company expects to recognize revenue on approximately 80-85% of the remaining performance obligations over the next 12 months, with the remaining recognized thereafter. Our service maintenance agreements are generally one-year renewable agreements. We have adopted the practical expedient that allows us to not include service maintenance contracts with a total term of less than one year; therefore, we do not report unfulfilled performance obligations for service maintenance agreements.

Leases

We lease certain facilities, vehicles and equipment under noncancelable operating leases. The most significant portion of these noncancelable operating leases are for the facilities occupied by our corporate office and our operating locations. Leases with an initial term of 12 months or less are not recorded on the Balance Sheet. We account for lease components separately from the non-lease components. We have certain leases with variable payments based on an index as well as some short-term leases on equipment and facilities. Variable lease expense and short-term lease expense were not material to our financial statements and aggregated to \$6.1 million and \$6.2 million in the first nine months of 2020 and 2019, respectively. Lease right-of-use assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of our leases do not provide an implicit rate, we generally use our incremental borrowing rate based on the information available at commencement date in determining the present value of lease payments. The weighted average discount rate as of September 30, 2020 and December 31, 2019 was 4.2% and 3.9%, respectively. We recognize lease expense, including escalating lease payments and lease incentives, on a straight-line basis over the lease term. Lease expense for the three months ended September 30, 2020 and 2019 was \$8.0 million and \$6.5 million, respectively. Lease expense for the nine months ended September 30, 2020 and 2019 was \$21.4 million and \$18.3 million, respectively.

The lease terms generally range from three to ten years. Some leases include one or more options to renew, which may be exercised to extend the lease term. We include the exercise of lease renewal options in the lease term when it is reasonably certain that we will exercise the option and such exercise is at our sole discretion. The weighted average remaining lease term was 7.6 years at September 30, 2020 and 8.1 years at December 31, 2019.

A majority of the Company's real property leases are with individuals or entities with whom we have no other business relationship. However, in certain instances the Company enters into real property leases with current or former employees. Rent paid to related parties for the three months ended September 30, 2020 and 2019 was approximately \$2.0 million and \$0.7 million, respectively. Rent paid to related parties for the nine months ended September 30, 2020 and 2019 was approximately \$4.5 million and \$2.7 million, respectively.

If we decide to cancel or terminate a lease before the end of its term, we would typically owe the lessor the remaining lease payments under the term of the lease. Our lease agreements do not contain any material residual value guarantees or material restrictive covenants. On rare occasions we rent or sublease certain real estate assets that we no longer use to third parties.

The following table summarizes the lease assets and liabilities included in the consolidated Balance Sheet as follows (in thousands):

	September 30, 2020	December 31, 2019
Lease right-of-use assets	\$ 95,815	\$ 84,073
Lease liabilities:		
Other current liabilities	16,368	14,016
Long-term lease liabilities	81,638	72,697
Total lease liabilities	<u>\$ 98,006</u>	<u>\$ 86,713</u>

The maturities of lease liabilities are as follows (in thousands):

Year ending December 31—	
2020 (excluding the nine months ended September 30, 2020)	\$ 5,306
2021	19,397
2022	16,353
2023	14,172
2024	12,671
Thereafter	47,693
Total Lease Payments	115,592
Less—Present Value Discount	(17,586)
Present Value of Lease Liabilities	<u>\$ 98,006</u>

Supplemental information related to leases was as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Cash paid for amounts included in the measurement of lease liabilities	\$ 5,362	\$ 4,566	\$ 15,140	\$ 12,439
Lease right-of-use assets obtained in exchange for lease liabilities	\$ 1,880	\$ 6,865	\$ 24,080	\$ 21,262

Income Taxes

We conduct business throughout the United States in virtually all fifty states. Our effective tax rate changes based upon our relative profitability, or lack thereof, in states with varying tax rates and rules. In addition, discrete items, such as tax law changes, judgments and legal structures, can impact our effective tax rate. These items can also include the tax treatment for impairment of goodwill and other intangible assets, changes in fair value of acquisition-related assets and liabilities, tax reserves for uncertain tax positions and accounting for losses associated with underperforming operations.

In the third quarter of 2019, we filed an amended federal return for 2015 to claim the credit for increasing research activities (the “R&D tax credit”) and recorded a \$4.6 million tax benefit that was fully offset by an increase in unrecognized tax benefits. We previously filed an amended federal return for 2014 to claim R&D tax credits during 2018 and recorded a \$2.7 million tax benefit that was also fully offset by an increase in unrecognized tax benefits. These tax benefits were fully offset by increases in unrecognized tax benefits due to the uncertainty of the outcome from examinations opened by the Internal Revenue Service (the “IRS”). As a result, the R&D tax credits claimed had no impact on our effective tax rates.

For the year ended December 31, 2019, our provision for income taxes was reduced by \$2.2 million due to benefits from the filing, and expected filing, of amended returns to claim the energy efficient commercial buildings deduction (the “179D deduction”) allocated to us.

During the third quarter of 2020, the IRS completed its examination of our amended federal returns for 2014 and 2015 and issued a Revenue Agent Report allowing the \$8.9 million of refund claims in full. Subsequently, the Joint Committee on Taxation reviewed and approved the refund claims. As a result, our provision for income taxes was reduced by \$8.3 million due to a decrease in unrecognized tax benefits of which \$1.0 million related to the 179D deduction.

In early October 2020, we filed amended federal returns for 2016, 2017 and 2018 to claim the R&D tax credit and 179D deduction and recorded tax benefits of \$6.1 million, \$8.5 million and \$11.9 million, respectively. The \$26.5 million of tax benefits have been offset by an increase in unrecognized tax benefits of \$26.4 million due to the uncertainty of the outcome of future IRS examinations. The R&D tax credit and 179D deduction for 2016, 2017 and 2018, therefore, had no material impact on our effective tax rates for the third quarter 2020. At this time, we cannot reasonably estimate the R&D tax credit for years after 2018 or 179D deduction for years after 2017.

Financial Instruments

Our financial instruments consist of cash and cash equivalents, accounts receivable, other receivables, accounts payable, interest rate swaps, life insurance policies, notes to former owners, a revolving credit facility and a term loan. We believe that the carrying values of these instruments on the accompanying Balance Sheets approximate their fair values.

3. Fair Value Measurements

Interest Rate Risk Management and Derivative Instruments

In April 2020, we entered into interest rate swap agreements to reduce our exposure to variable interest rates on our term loan and revolving credit facility. The notional amount covered by these interest rate swaps was \$200.0 million as of September 30, 2020 and gradually decreases to \$80.0 million by November 30, 2021 until the termination date of September 30, 2022.

We use derivative instruments to manage exposure to market risk, including interest rate risk. All of our current derivatives are designated and accounted for as economic hedges. Unsettled amounts under our economic hedges are recorded on the Balance Sheet at fair value in “Other Receivables” or “Other Current Liabilities.” Gains and losses on our interest rate swaps are recorded on the Income Statement in “Interest Expense.” For the three and nine months ended September 30, 2020, we recognized a net loss of less than \$0.2 million related to our interest rate swaps. We currently do not have any derivatives that are accounted for as hedges under ASC 815.

Fair Value Measurements

We classify and disclose assets and liabilities carried at fair value in one of the following three categories:

- Level 1—quoted prices in active markets for identical assets and liabilities;
- Level 2—observable market-based inputs or unobservable inputs that are corroborated by market data; and
- Level 3—significant unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

The following table summarizes the fair values, and levels within the fair value hierarchy in which the fair value measurements fall, for assets and liabilities measured on a recurring basis as of September 30, 2020 and December 31, 2019 (in thousands):

	Fair Value Measurements at September 30, 2020			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 70,540	\$ —	\$ —	\$ 70,540
Life insurance—cash surrender value	\$ —	\$ 4,729	\$ —	\$ 4,729
Contingent earn-out obligations	\$ —	\$ —	\$ 25,962	\$ 25,962
Interest rate swaps	\$ —	\$ 62	\$ —	\$ 62

	Fair Value Measurements at December 31, 2019			
	Level 1	Level 2	Level 3	Total
Cash and cash equivalents	\$ 50,788	\$ —	\$ —	\$ 50,788
Life insurance—cash surrender value	\$ —	\$ 3,905	\$ —	\$ 3,905
Contingent earn-out obligations	\$ —	\$ —	\$ 28,497	\$ 28,497

Cash and cash equivalents consist primarily of highly rated money market funds at a variety of well-known institutions with original maturities of three months or less. The original cost of these assets approximates fair value due to their short-term maturity. The fair value for our interest rate swaps is based upon inputs corroborated by observable market data with similar tenors, which are considered Level 2 inputs. The Company’s outstanding term loan held by third-party financial institutions is carried at cost, adjusted for debt issuance costs. The Company’s term loan is not publicly traded and the carrying amount approximates fair value as the loan accrues interest at a variable rate. The

carrying value of our borrowings associated with the revolving credit facility approximate its fair value due to the variable rate on such debt.

We have life insurance policies covering 74 employees with a combined face value of \$54.2 million. The policies are invested in several investment vehicles, and the fair value measurement of the cash surrender balance associated with these policies is determined using Level 2 inputs within the fair value hierarchy and will vary with investment performance. The cash surrender value of these policies was \$4.7 million as of September 30, 2020 and \$3.9 million as of December 31, 2019. These assets are included in “Other Noncurrent Assets” in our consolidated Balance Sheets.

We value contingent earn-out obligations using a probability weighted discounted cash flow method. This fair value measurement is based on significant unobservable inputs in the market and thus represents a Level 3 measurement within the fair value hierarchy. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payments, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate. The contingent earn-out obligations are measured at fair value each reporting period, and changes in estimates of fair value are recognized in earnings. Significant unobservable inputs that could impact the fair value measurement include our weighted average cost of capital and the forecasted level of operating income for each earn-out measurement. As of September 30, 2020, cash flows were discounted using a weighted average cost of capital ranging from 9.5% - 16.0%.

The table below presents a reconciliation of the fair value of our contingent earn-out obligations that use significant unobservable inputs (Level 3) (in thousands):

	Nine Months Ended September 30, 2020	Year Ended December 31, 2019
Balance at beginning of period	\$ 28,497	\$ 7,375
Issuances	9,155	19,500
Settlements	(9,866)	(1,369)
Adjustments to fair value	(1,824)	2,991
Balance at end of period	<u>\$ 25,962</u>	<u>\$ 28,497</u>

We measure certain assets at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. We did not recognize any impairments in the current year on those assets required to be measured at fair value on a nonrecurring basis.

4. Acquisitions

TAS Energy Inc. Acquisition

On April 1, 2020, we consummated a merger through which TAS Energy Inc. (“TAS”) became a wholly owned subsidiary of the Company. TAS is headquartered in Houston, Texas and is a leading engineering, design and construction provider of modular construction systems serving the technology, power and industrial sectors. As a result of the acquisition, TAS is a wholly owned subsidiary of the Company reported in our mechanical services segment.

The following summarizes the acquisition date fair value of consideration transferred and the acquisition date fair value of the identifiable assets acquired and liabilities assumed, including an amount for goodwill (in thousands):

Consideration transferred:	
Cash paid at closing	\$ 105,950
Working capital adjustment	39,715
Notes issued to former owners	14,000
Estimated fair value of contingent earn-out payments	9,100
	<u>\$ 168,765</u>

Recognized amounts of identifiable assets acquired and liabilities assumed:	
Cash and cash equivalents	\$ 47,460
Billed and unbilled accounts receivable	18,702
Other current assets	15,634
Other long-term assets	935
Property and equipment	7,709
Goodwill	73,409
Identifiable intangible assets	53,400
Lease right-of-use asset	19,736
Accounts payable	(16,453)
Billings in excess of costs and estimated earnings	(24,196)
Current lease liabilities	(2,337)
Accrued expenses and other current liabilities	(4,849)
Long-term lease liabilities	(17,398)
Other long-term liabilities	(2,987)
	<u>\$ 168,765</u>

The allocation of the purchase price to the assets acquired and liabilities assumed is preliminary and, therefore, subject to change pending the completion of the final valuation of intangible assets and accrued liabilities. Goodwill represents the future economic benefits arising from other assets acquired that could not be individually identified and separately recognized. The goodwill recognized as a result of the TAS acquisition is not deductible for tax purposes.

In estimating the fair value of the acquired intangible assets, we utilized the valuation methodology determined to be the most appropriate for the individual intangible asset. In order to estimate the fair value of the backlog and customer relationships, we utilized an excess earnings methodology, which consisted of the projected cash flows attributable to these assets discounted to present value using a risk-adjusted discount rate that represented the required rate of return. The trade name value was determined based on the relief-from-royalty method, which applies a royalty rate to the revenue stream attributable to this asset, and the resulting royalty payment is tax effected and discounted to present value. Some of the more significant estimates and assumptions inherent in determining the fair value of the identifiable intangible assets are associated with forecasting cash flows and profitability, which represent Level 3 inputs. The primary assumptions used were generally based upon the present value of anticipated cash flows discounted at rates ranging from 15% - 23.5%. Estimated years of projected earnings generally follow the range of estimated remaining useful lives for each intangible asset class.

As a result of the TAS acquisition, we acquired an estimated \$55.5 million of federal net operating loss (“NOL”) carryforwards and \$6.5 million of state NOL carryforwards. Our ability to utilize these NOL carryforwards to reduce taxable income in future years is subject to significant limitations under Section 382 of the Internal Revenue Code due to the ownership change in TAS on April 1, 2020. While we expect to fully utilize the federal NOL carryforwards before they begin to expire in 2031, a full valuation allowance was recorded against the state NOL carryforwards. We do not believe it is more-likely-than-not that we will have sufficient revenue-generating operations in those states in the future.

The acquired intangible assets include the following (dollars in thousands):

	Valuation Method	Estimated Useful Life	Estimated Fair Value
Backlog	Excess earnings	1 year	\$ 5,200
Trade Name	Relief-from-royalty	25 years	8,200
Customer Relationships	Excess earnings	10 years	40,000
Total			<u>\$ 53,400</u>

The contingent earn-out obligation is associated with the achievement of two earnings milestones over a 27-month period, and the range of each estimated milestone payment is \$1 million to \$8 million. We determined the initial fair value of the contingent earn-out obligation based on the Monte Carlo Simulation method, which represents a Level 3 measurement. Cash flows were discounted using a 17.7% discount rate, which we believe is appropriate and

representative of a market participant assumption. Subsequent to the acquisition date, the contingent earn-out obligation is remeasured at fair value each reporting period. Changes in the estimated fair value of the contingent payments subsequent to the acquisition date are recognized immediately in earnings.

Other Acquisitions

We completed the acquisition of the electrical contractor in North Carolina in the first quarter of 2020 with a total preliminary purchase price of \$41.6 million. This acquisition is reported in our electrical services segment. We completed the acquisition of Walker, which is reported in our electrical services segment, in the second quarter of 2019 with a total purchase price of \$235.4 million. In 2019, in addition to the Walker acquisition, we completed one acquisition in the first quarter of 2019 and one acquisition in the second quarter of 2019 with a total purchase price of \$2.6 million.

The results of operations of acquisitions are included in our consolidated financial statements from their respective acquisition dates. Our consolidated Balance Sheet includes preliminary allocations of the purchase price to the assets acquired and liabilities assumed for the applicable acquisitions pending the completion of the final valuation of intangible assets and accrued liabilities. Excluding the Walker and TAS acquisitions, the acquisitions completed in the current and prior year were not material, individually or in the aggregate. Additional contingent purchase price (“earn-out”) has been or will be paid if certain acquisitions achieve predetermined profitability targets. Such earn-outs, when they are not subject to the continued employment of the sellers, are estimated as of the purchase date and included as part of the consideration paid for the acquisition. If we have an earn-out under which continued employment is a condition to receipt of payment, then the earn-out is recorded as compensation expense over the period earned.

5. Goodwill and Identifiable Intangible Assets, Net

Goodwill

The changes in the carrying amount of goodwill are as follows (in thousands):

	Mechanical Services Segment	Electrical Services Segment	Total
Balance at December 31, 2018	\$ 235,182	\$ —	\$ 235,182
Acquisitions and purchase price adjustments (See Note 4)	579	96,686	97,265
Impact of segment reorganization	(1,101)	1,101	—
Balance at December 31, 2019	234,660	97,787	332,447
Acquisitions and purchase price adjustments (See Note 4)	73,409	14,926	88,335
Balance at September 30, 2020	<u>\$ 308,069</u>	<u>\$ 112,713</u>	<u>\$ 420,782</u>

During the fourth quarter of 2019, the Company performed its annual goodwill impairment test resulting in no impairment charges, as the calculated fair values for the majority of the Company’s reporting units that have goodwill were significantly in excess (all greater than 80%) of the respective reporting unit’s carrying value, while two reporting units that were recently acquired had calculated fair values in excess of carrying value of at least 27%. During the first quarter of 2020, we considered the economic impacts of COVID-19 to be a triggering event for review of goodwill impairment at each of our reporting units. After performing a qualitative goodwill impairment assessment as of March 31, 2020, we determined that we did not have a goodwill impairment as of that date. As a result of uncertainty caused by COVID-19 and Walker’s smaller excess of fair value percentage, this reporting unit is more susceptible to impairment risk from additional adverse changes in its operating environment, including micro- and macroeconomic environment conditions that could negatively impact them. Such adverse changes could include worsening economic conditions in the locations or markets they primarily serve, whether due to COVID-19 or other events and conditions. As of September 30, 2020, Walker had a goodwill balance of \$96.8 million.

Identifiable Intangible Assets, Net

Identifiable intangible assets consist of the following (dollars in thousands):

	Estimated Useful Lives in Years	September 30, 2020		December 31, 2019	
		Gross Book Value	Accumulated Amortization	Gross Book Value	Accumulated Amortization
Customer relationships	1 - 15	\$ 231,492	\$ (97,901)	\$ 183,061	\$ (80,813)
Backlog	1 - 2	12,600	(12,098)	7,400	(6,388)
Tradenames	2 - 25	85,695	(17,790)	71,995	(15,281)
Total		<u>\$ 329,787</u>	<u>\$ (127,789)</u>	<u>\$ 262,456</u>	<u>\$ (102,482)</u>

The amounts attributable to customer relationships and tradenames are amortized to “Selling, General and Administrative Expenses” based upon the estimated consumption of their economic benefits, or a straight-line method over periods from one to twenty-five years, if the pattern of economic benefit cannot otherwise be reliably estimated. The amounts attributable to backlog are being amortized to “Cost of Services” on a proportionate method over the remaining backlog period. Amortization expense for the three and nine months ended September 30, 2020 was \$8.2 million and \$25.3 million, respectively. Amortization expense for the three and nine months ended September 30, 2019 was \$7.2 million and \$20.2 million, respectively.

At September 30, 2020, future amortization expense of identifiable intangible assets is as follows (in thousands):

Year ended December 31—	
2020 (remainder of the year)	\$ 7,391
2021	24,610
2022	21,989
2023	20,535
2024	19,185
Thereafter	108,288
Total	<u>\$ 201,998</u>

6. Debt Obligations

Debt obligations consist of the following (in thousands):

	September 30, 2020	December 31, 2019
Revolving credit facility	\$ 61,500	\$ 28,000
Term loan	135,000	150,000
Notes to former owners	26,050	48,483
Other debt	20	—
Total principal amount	222,570	226,483
Less—unamortized debt issuance costs	(287)	(348)
Total debt, net of unamortized debt issuance costs	222,283	226,135
Less—current portion	(70)	(20,817)
Total long-term portion of debt, net	<u>\$ 222,213</u>	<u>\$ 205,318</u>

Revolving Credit Facility and Term Loan

In December 2019, we amended our senior credit facility (the “Facility”) provided by a syndicate of banks, increasing our borrowing capacity from \$400.0 million to \$600.0 million. As amended, the Facility is composed of a revolving credit line in the amount of \$450.0 million and a \$150.0 million term loan, and the Facility provides for a \$150.0 million accordion or increase option for the revolving portion of the Facility. The amended Facility also includes a sublimit of up to \$160.0 million issuable in the form of letters of credit. The Facility expires in January 2025 and is

secured by a first lien on substantially all of our personal property except for assets related to projects subject to surety bonds and assets held by certain unrestricted subsidiaries and our wholly owned captive insurance company, and a second lien on our assets related to projects subject to surety bonds. In connection with the amendment in December 2019, we incurred approximately \$1.4 million in financing and professional costs that are being amortized over the remaining term of the Facility. Of this amount, \$0.4 million is attributable to the term loan and is being amortized using the effective interest method. The remaining \$1.0 million is attributable to the revolving credit line, which combined with the previous unamortized costs of \$1.3 million, is being amortized over the remaining term of the Facility on a straight-line basis as a non-cash charge to interest expense. For the term loan, we are required to make quarterly payments increasing over time from 1.25% to 3.75% of the original aggregate principal amount of the term loan, with the balance due in January 2025. As of September 30, 2020, we had \$61.5 million of outstanding borrowings on the revolving credit facility, \$55.6 million in letters of credit outstanding and \$332.9 million of credit available.

There are two interest rate options for borrowings under the Facility, the Base Rate Loan Option and the Eurodollar Rate Loan Option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

The following is a summary of the additional margins:

	Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA			
	Less than 1.00	1.00 to 1.75	1.75 to 2.50	2.50 or greater
Additional Per Annum Interest Margin Added Under:				
Base Rate Loan Option	0.25 %	0.50 %	0.75 %	1.00 %
Eurodollar Rate Loan Option	1.25 %	1.50 %	1.75 %	2.00 %

The weighted average interest rate applicable to the borrowings under the revolving credit facility was approximately 1.4% as of September 30, 2020. The weighted average interest rate applicable to the term loan was approximately 1.4% as of September 30, 2020.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. Our lenders issue such letters of credit through the Facility. We have never had a claim made against a letter of credit that resulted in payments by a lender or by us and believe such a claim is unlikely in the foreseeable future. The letter of credit fees range from 1.25% to 2.00% per annum, based on the ratio of Consolidated Total Indebtedness to "Credit Facility Adjusted EBITDA," which shall mean Consolidated EBITDA as such term is defined in the credit agreement.

Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20% to 0.35% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. Covenant compliance is assessed as of each quarter end.

The Facility's principal financial covenants include:

Total Leverage Ratio—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed 3.00 to 1.00 as of the end of each fiscal quarter. The leverage ratio as of September 30, 2020 was 0.8.

Fixed Charge Coverage Ratio—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, provision for income taxes, dividends and amounts used to repurchase stock when the Company's Total Leverage Ratio exceeds 2.00 to 1.00 to (b) the sum of interest expense and scheduled principal payments of indebtedness be at least 1.50 to 1.00. Credit Facility Adjusted EBITDA, capital expenditures, provision for

income taxes, dividends, stock repurchase payments, interest expense, and scheduled principal payments are defined under the Facility for purposes of this covenant, to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of September 30, 2020 was 6.6.

Other Restrictions—The Facility permits acquisitions of up to \$5.0 million per transaction, provided that the aggregate purchase price of such an acquisition and of acquisitions in the same fiscal year does not exceed \$10.0 million. However, these limitations only apply when the Company's Total Leverage Ratio is greater than 2.50 to 1.00.

While the Facility's financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility's leverage ratio covenant, our borrowing capacity under the Facility and the favorable terms that we currently have could be negatively impacted by the lenders.

We were in compliance with all of our financial covenants as of September 30, 2020.

Notes to Former Owners

As part of the consideration used to acquire four companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$26.1 million as of September 30, 2020. In conjunction with the acquisition of TAS in the second quarter of 2020, we issued a promissory note to former owners with an outstanding balance of \$8.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.5%. The principal is due in April 2022. In conjunction with the acquisition of the electrical contractor in North Carolina in the first quarter of 2020, we issued a promissory note to former owners with an outstanding balance of \$8.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.0%. The principal is due in equal installments in February 2023 and February 2024. In conjunction with the Walker acquisition in the second quarter of 2019, we issued a promissory note to former owners with an outstanding balance of \$10.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 4.0%. The principal is due in April 2023. In conjunction with one immaterial acquisition in 2019, we issued a note to former owners with an outstanding balance of \$0.1 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.0%. The principal is due in January 2021.

7. Commitments and Contingencies

Claims and Lawsuits

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

Surety

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

Current market conditions for surety markets and bonding capacity are adequate, with acceptable terms and conditions. Historically, approximately 15% to 25% of our business has required bonds. While we currently have strong surety relationships to support our bonding needs, future market conditions or changes in the sureties' assessment of our

operating and financial risk could cause the sureties to decline to issue bonds for our work. If that were to occur, the alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance, such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenue and profits to decline in the near term.

Self-Insurance

We are substantially self-insured for workers' compensation, employer's liability, auto liability, general liability and employee group health claims, in view of the relatively high per-incident deductibles we absorb under our insurance arrangements for these risks. Losses are estimated and accrued based upon known facts, historical trends and industry averages. Estimated losses in excess of our deductible, which have not already been paid, are included in our accrual with a corresponding receivable from our insurance carrier. Loss estimates associated with the larger and longer-developing risks, such as workers' compensation, auto liability and general liability, are reviewed by a third-party actuary quarterly.

8. Stockholders' Equity

Earnings Per Share

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year. Diluted EPS is computed considering the dilutive effect of stock options, restricted stock, restricted stock units and performance stock units. The vesting of unvested, contingently issuable performance stock units is based on the achievement of certain earnings per share targets and total shareholder return. These shares are considered contingently issuable shares for purposes of calculating diluted earnings per share. These shares are not included in the diluted earnings per share denominator until the performance criteria are met, if it is assumed that the end of the reporting period was the end of the contingency period.

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

There were less than 0.1 million anti-dilutive stock options excluded from the calculation of diluted EPS for the three and nine months ended September 30, 2020 and 2019, respectively.

The following table reconciles the number of shares outstanding with the number of shares used in computing basic and diluted earnings per share for each of the periods presented (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
Common shares outstanding, end of period	36,400	36,676	36,400	36,676
Effect of using weighted average common shares outstanding	157	129	204	215
Shares used in computing earnings per share—basic	36,557	36,805	36,604	36,891
Effect of shares issuable under stock option plans based on the treasury stock method	125	181	124	211
Effect of restricted and contingently issuable shares	68	65	69	68
Shares used in computing earnings per share—diluted	<u>36,750</u>	<u>37,051</u>	<u>36,797</u>	<u>37,170</u>

Share Repurchase Program

On March 29, 2007, our Board of Directors (the "Board") approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On November 19,

2019, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.8 million shares. Since the inception of the repurchase program, the Board has approved 9.5 million shares to be repurchased. As of September 30, 2020, we have repurchased a cumulative total of 9.1 million shares at an average price of \$18.89 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. In an exercise of such discretion, we suspended share repurchases from March 27, 2020 to May 26, 2020 in response to the uncertainty surrounding the current COVID-19 pandemic, as more fully described in “Item 1A. Risk Factors” herein. The Board may modify, suspend, extend or terminate the program at any time. During the nine months ended September 30, 2020, we repurchased 0.4 million shares for approximately \$18.8 million at an average price of \$41.90 per share.

9. Segment Information

Our activities are within the mechanical services industry and the electrical services industry, which represent our two reportable segments. We aggregate our operating segments into two reportable segments, as the operating segments meet all of the aggregation criteria. The following table presents information about our reportable segments (in thousands):

	Three Months Ended September 30, 2020			
	Mechanical Services	Electrical Services	Corporate	Consolidated
Revenue	\$ 621,140	\$ 92,959	\$ —	\$ 714,099
Gross Profit	\$ 138,655	\$ 8,541	\$ —	\$ 147,196

	Three Months Ended September 30, 2019			
	Mechanical Services	Electrical Services	Corporate	Consolidated
Revenue	\$ 590,016	\$ 116,902	\$ —	\$ 706,918
Gross Profit	\$ 128,501	\$ 14,201	\$ —	\$ 142,702

	Nine Months Ended September 30, 2020			
	Mechanical Services	Electrical Services	Corporate	Consolidated
Revenue	\$ 1,809,304	\$ 348,394	\$ —	\$ 2,157,698
Gross Profit	\$ 383,334	\$ 26,650	\$ —	\$ 409,984

	Nine Months Ended September 30, 2019			
	Mechanical Services	Electrical Services	Corporate	Consolidated
Revenue	\$ 1,677,632	\$ 218,061	\$ —	\$ 1,895,693
Gross Profit	\$ 344,632	\$ 24,751	\$ —	\$ 369,383

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis should be read in conjunction with our historical Consolidated Financial Statements and related notes included elsewhere in this Form 10-Q and the Annual Report on Form 10-K filed with the Securities and Exchange Commission for the year ended December 31, 2019 (the "Form 10-K"). This discussion contains "forward-looking statements" regarding our business and industry within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on our current plans and expectations and involve risks and uncertainties that could cause our actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in "Item 1A. Risk Factors" included in our Form 10-K. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements, except as required by law. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. The terms "Comfort Systems," "we," "us," or the "Company," refer to Comfort Systems USA, Inc. or Comfort Systems USA, Inc. and its consolidated subsidiaries, as appropriate in the context.

Introduction and Overview

We are a national provider of comprehensive mechanical and electrical installation, renovation, maintenance, repair and replacement services within the mechanical and electrical services industries. We operate primarily in the commercial, industrial and institutional markets and perform most of our services within office buildings, retail centers, apartment complexes, manufacturing plants, and healthcare, education and government facilities. We operate our business in two business segments: mechanical and electrical.

Nature and Economics of Our Business

In our mechanical business segment, customers hire us to ensure HVAC systems deliver specified or generally expected heating, cooling, conditioning and circulation of air in a facility. This entails installing core system equipment such as packaged heating and air conditioning units, or in the case of larger facilities, separate core components such as chillers, boilers, air handlers, and cooling towers. We also typically install connecting and distribution elements such as piping and ducting.

In our electrical business segment, our principal business activity is electrical construction and engineering in the commercial and industrial field. We also perform electrical logistics services, electrical service work, and electrical construction and engineering services.

In both our mechanical and electrical business segments, our responsibilities usually require conforming the systems to pre-established engineering drawings and equipment and performance specifications, which we frequently participate in establishing. Our project management responsibilities include staging equipment and materials to project sites, deploying labor to perform the work, and coordinating with other service providers on the project, including any subcontractors we might use to deliver our portion of the work.

Approximately 87.2% of our revenue is earned on a project basis for installation services in newly constructed facilities or for replacement of systems in existing facilities. When competing for project business, we usually estimate the costs we will incur on a project, and then propose a bid to the customer that includes a contract price and other performance and payment terms. Our bid price and terms are intended to cover our estimated costs on the project and provide a profit margin to us commensurate with the value of the installed system to the customer, the risk that project costs or duration will vary from estimate, the schedule on which we will be paid, the opportunities for other work that we might forego by committing capacity to this project, and other costs that we incur to support our operations but which are not specific to the project. Typically, customers will seek pricing from competitors for a given project. While the criteria on which customers select a service provider vary widely and include factors such as quality, technical expertise, on-time performance, post-project support and service, and company history and financial strength, we believe that price for value is the most influential factor for most customers in choosing a mechanical or electrical installation and service provider.

After a customer accepts our bid, we generally enter into a contract with the customer that specifies what we will deliver on the project, what our related responsibilities are, and how much and when we will be paid. Our overall price for the project is typically set at a fixed amount in the contract, although changes in project specifications or work conditions that result in unexpected additional work are usually subject to additional payment from the customer via what are commonly known as change orders. Project contracts typically provide for periodic billings to the customer as we meet progress milestones or incur cost on the project. Project contracts in our industry also frequently allow for a small portion of progress billings or contract price to be withheld by the customer until after we have completed the work. Amounts withheld under this practice are known as retention or retainage.

Labor and overhead costs account for the majority of our cost of service. Accordingly, labor management and utilization have the most impact on our project performance. Given the fixed price nature of much of our project work, if our initial estimate of project costs is wrong or we incur cost overruns that cannot be recovered in change orders, we can experience reduced profits or even significant losses on fixed price project work. We also perform some project work on a cost-plus or a time and materials basis, under which we are paid our costs incurred plus an agreed-upon profit margin, and such projects are sometimes subject to a guaranteed maximum cost. These margins are frequently less than fixed-price contract margins because there is less risk of unrecoverable cost overruns in cost-plus or time and materials work.

As of September 30, 2020, we had 6,022 projects in process. Our average project takes six to nine months to complete, with an average contract price of approximately \$835,000. Our projects generally require working capital funding of equipment and labor costs. Customer payments on periodic billings generally do not recover these costs until late in the job. Our average project duration, together with typical retention terms as discussed above, generally allow us to complete the realization of revenue and earnings in cash within one year. We have what we consider to be a well-diversified distribution of revenue across end-use sectors that we believe reduces our exposure to negative developments in any given sector. Because of the integral nature of our services to most buildings, we have the legal right in almost all cases to attach liens to buildings or related funding sources when we have not been fully paid for installing systems, except with respect to some government buildings. The service work that we do, which is discussed further below, usually does not give rise to lien rights.

We also perform larger projects. Taken together, projects with contract prices of \$1 million or more totaled \$4.4 billion of aggregate contract value as of September 30, 2020, or approximately 87% of a total contract value for all projects in progress, totaling \$5.0 billion. It is unusual for us to work on a project that exceeds two years in length.

A stratification of projects in progress as of September 30, 2020, by contract price, is as follows:

Contract Price of Project	No. of Projects	Aggregate Contract Price Value (millions)
Under \$1 million	5,214	\$ 662.6
\$1 million - \$5 million	595	1,326.1
\$5 million - \$10 million	102	740.3
\$10 million - \$15 million	58	710.1
Greater than \$15 million	53	1,588.0
Total	6,022	\$ 5,027.1

In addition to project work, approximately 12.8% of our revenue represents maintenance and repair service on already installed HVAC, electrical, and controls systems. This kind of work usually takes from a few hours to a few days to perform. Prices to the customer are based on the equipment and materials used in the service as well as technician labor time. We usually bill the customer for service work when it is complete, typically with payment terms of up to thirty days. We also provide maintenance and repair service under ongoing contracts. Under these contracts, we are paid regular monthly or quarterly amounts and provide specified service based on customer requirements. These agreements typically are for one or more years and frequently contain thirty- to sixty-day cancellation notice periods.

A relatively small portion of our revenue comes from national and regional account customers. These customers typically have multiple sites and contract with us to perform maintenance and repair service. These contracts may also

provide for us to perform new or replacement systems installation. We operate a national call center to dispatch technicians to sites requiring service. We perform the majority of this work with our own employees, with the balance being subcontracted to third parties that meet our performance qualifications.

Profile and Management of Our Operations

We manage our 36 operating units based on a variety of factors. Financial measures we emphasize include profitability and use of capital as indicated by cash flow and by other measures of working capital principally involving project cost, billings and receivables. We also monitor selling, general, administrative and indirect project support expense, backlog, workforce size and mix, growth in revenue and profits, variation of actual project cost from original estimate, and overall financial performance in comparison to budget and updated forecasts. Operational factors we emphasize include project selection, estimating, pricing, management and execution practices, labor utilization, safety, training, and the make-up of both existing backlog as well as new business being pursued, in terms of project size, technical application, facility type, end-use customers and industries and location of the work.

Most of our operations compete on a local or regional basis. Attracting and retaining effective operating unit managers is an important factor in our business, particularly in view of the relative uniqueness of each market and operation, the importance of relationships with customers and other market participants, such as architects and consulting engineers, and the high degree of competition and low barriers to entry in most of our markets. Accordingly, we devote considerable attention to operating unit management quality, stability, and contingency planning, including related considerations of compensation and non-competition protection where applicable.

Economic and Industry Factors

As a mechanical and electrical services provider, we operate in the broader nonresidential construction services industry and are affected by trends in this sector. While we do not have operations in all major cities of the United States, we believe our national presence is sufficiently large that we experience trends in demand for and pricing of our services that are consistent with trends in the national nonresidential construction sector. As a result, we monitor the views of major construction sector forecasters along with macroeconomic factors they believe drive the sector, including trends in gross domestic product, interest rates, business investment, employment, demographics and the fiscal condition of federal, state and local governments.

Spending decisions for building construction, renovation and system replacement are generally made on a project basis, usually with some degree of discretion as to when and if projects proceed. With larger amounts of capital, time, and discretion involved, spending decisions are affected to a significant degree by uncertainty, particularly concerns about economic and financial conditions and trends. We have experienced periods of time when economic weakness caused a significant slowdown in decisions to proceed with installation and replacement project work.

Operating Environment and Management Emphasis

Nonresidential building construction and renovation activity, as reported by the federal government, declined steeply over the four-year period from 2009 to 2012, and 2013 and 2014 activity levels were relatively stable at the low levels of the preceding years. During the five-year period from 2015 to 2019, there was an increase in overall activity levels.

We have a credit facility in place with terms we believe are favorable that does not expire until January 2025. As of September 30, 2020, we had \$332.9 million of credit available to borrow under our credit facility. We have strong surety relationships to support our bonding needs, and we believe our relationships with the surety markets are strong and benefit from our operating history and financial position. We have generated positive free cash flow in each of the last twenty-one calendar years and will continue our emphasis in this area. We believe that the relative size and strength of our Balance Sheet and surety relationships, as compared to most companies in our industry, represent competitive advantages for us.

As discussed at greater length in “Results of Operations” below, we expect price competition to continue as our customers and local and regional competitors compete for customers. We will continue to invest in our service business, to pursue the more active sectors in our markets, and to emphasize our regional and national account business.

Cyclicality and Seasonality

Historically, the construction industry has been highly cyclical. As a result, our volume of business, particularly in new construction projects and renovation, may be adversely affected by declines in new installation and replacement projects in various geographic regions of the United States during periods of economic weakness.

The mechanical and electrical contracting industries are subject to seasonal variations. The demand for new installation and replacement is generally lower during the winter months (the first quarter of the year) due to reduced construction activity during inclement weather and less use of air conditioning during the colder months. Demand for our services is generally higher in the second and third calendar quarters due to increased construction activity and increased use of air conditioning during the warmer months. Accordingly, we expect our revenue and operating results generally will be lower in the first calendar quarter.

Results of Operations (dollars in thousands):

	<u>Three Months Ended September 30,</u>				<u>Nine Months Ended September 30,</u>			
	<u>2020</u>		<u>2019</u>		<u>2020</u>		<u>2019</u>	
Revenue	\$ 714,099	100.0 %	\$ 706,918	100.0 %	\$ 2,157,698	100.0 %	\$ 1,895,693	100.0 %
Cost of services	566,903	79.4 %	564,216	79.8 %	1,747,714	81.0 %	1,526,310	80.5 %
Gross profit	147,196	20.6 %	142,702	20.2 %	409,984	19.0 %	369,383	19.5 %
Selling, general and administrative expenses	90,888	12.7 %	90,006	12.7 %	268,857	12.5 %	253,417	13.4 %
Gain on sale of assets	(377)	(0.1)%	(708)	(0.1)%	(1,243)	(0.1)%	(1,119)	(0.1)%
Operating income	56,685	7.9 %	53,404	7.6 %	142,370	6.6 %	117,085	6.2 %
Interest income	7	—	82	—	99	—	174	—
Interest expense	(1,733)	(0.2)%	(2,779)	(0.4)%	(6,904)	(0.3)%	(6,891)	(0.4)%
Changes in the fair value of contingent earn-out obligations	3,423	0.5 %	(2,004)	(0.3)%	1,824	0.1 %	(3,924)	(0.2)%
Other income (expense)	(15)	—	3	—	10	—	167	—
Income before income taxes	58,367	8.2 %	48,706	6.9 %	137,399	6.4 %	106,611	5.6 %
Provision for income taxes	8,279		12,473		30,100		26,339	
Net income	<u>\$ 50,088</u>	7.0 %	<u>\$ 36,233</u>	5.1 %	<u>\$ 107,299</u>	5.0 %	<u>\$ 80,272</u>	4.2 %

We had 35 operating locations as of December 31, 2019. In the second quarter of 2020, we completed the acquisition of TAS, which reports as a separate operating location. As of September 30, 2020, we had 36 operating locations. Acquisitions are included in our results of operations from the respective acquisition date. The same-store comparison from 2020 to 2019, as described below, excludes three months of results for Walker, which was acquired April 1, 2019, eight months of results for our electrical contractor in North Carolina, which was acquired February 1, 2020 and reports together with our existing North Carolina operation and six months of results for TAS, which was acquired on April 1, 2020. An operating location is included in the same-store comparison on the first day it has comparable prior year operating data, except for immaterial acquisitions that were absorbed and integrated, or “tucked-in,” with existing operations. While the electrical contractor in North Carolina is tucked-in with our existing North Carolina operation, due to the size of the acquired operations, we have elected to exclude their results from our same-store comparison.

Revenue—Revenue for the third quarter of 2020 increased \$7.2 million, or 1.0%, to \$714.1 million compared to the same period in 2019. The increase included a 6.8% increase related to the North Carolina electrical contractor and TAS acquisitions and a 5.8% decrease in revenue related to same-store activity.

The following table presents our operating segment revenue (in thousands, except percentages):

	Three Months Ended September 30,			
	2020		2019	
Revenue:				
Mechanical Services	\$ 621,140	87.0 %	\$ 590,016	83.5 %
Electrical Services	92,959	13.0 %	116,902	16.5 %
Total	<u>\$ 714,099</u>	<u>100.0 %</u>	<u>\$ 706,918</u>	<u>100.0 %</u>

Revenue for our mechanical services segment increased \$31.1 million, or 5.3%, to \$621.1 million for the third quarter of 2020 compared to the same period in 2019. The increase included the acquisition of TAS in April 2020 (\$28.6 million) as well as an increase in activity in the education sector at one of our Virginia operations (\$14.2 million). This increase was offset by a decrease in activity in the education sector at our North Carolina operation (\$7.0 million) and in the healthcare sector at one of our Texas operations (\$6.1 million).

Revenue for our electrical services segment decreased \$23.9 million to \$93.0 million for the third quarter of 2020 compared to the same period in 2019. The decrease related to the impact of Coronavirus Disease 2019 (“COVID-19”) as well as expected decreases driven by a higher volume of large jobs in the prior period at our Walker operation (\$42.3 million). The decrease was partially offset by the acquisition of the electrical contractor in North Carolina (\$19.6 million).

Revenue for the first nine months of 2020 increased \$262.0 million, or 13.8%, to \$2.16 billion compared to the same period in 2019. The increase included a 13.5% increase related to the TAS, North Carolina electrical contractor and Walker acquisitions and a 0.3% increase in revenue related to same-store activity.

The following table presents our operating segment revenue (in thousands, except percentages):

	Nine Months Ended September 30,			
	2020		2019	
Revenue:				
Mechanical Services	\$ 1,809,304	83.9 %	\$ 1,677,632	88.5 %
Electrical Services	348,394	16.1 %	218,061	11.5 %
Total	<u>\$ 2,157,698</u>	<u>100.0 %</u>	<u>\$ 1,895,693</u>	<u>100.0 %</u>

Revenue for our mechanical services segment increased \$131.7 million, or 7.8%, to \$1.81 billion for the first nine months of 2020 compared to the same period in 2019. Of this increase, \$84.3 million was attributable to the TAS acquisition. The same-store revenue increase included an increase in activity in the industrial sector at our North Carolina operation (\$16.5 million), in the education sector at our Arizona operation (\$13.6 million) and at one of our Virginia operations (\$13.3 million), and in the government sector at one of our Tennessee operations (\$12.9 million). This increase was offset by the sale of the majority of the assets and ongoing business of our California operation in the third quarter of 2019 (\$13.8 million).

Revenue for our electrical services segment increased \$130.3 million to \$348.4 million for the first nine months of 2020 compared to the same period in 2019. The increase related to the acquisition of Walker in April 2019 as well as the acquisition of the electrical contractor in North Carolina in February 2020.

Backlog reflects revenue still to be recognized under contracted or committed installation and replacement project work. Project work generally lasts less than one year. Service agreement revenue and service work and short duration projects, which are generally billed as performed, do not flow through backlog. Accordingly, backlog represents only a portion of our revenue for any given future period, and it represents revenue that is likely to be reflected in our

operating results over the next six to twelve months. As a result, we believe the predictive value of backlog information is limited to indications of general revenue direction over the near term, and should not be interpreted as indicative of ongoing revenue performance over several quarters.

The following table presents our operating segment backlog (in thousands, except percentages):

	September 30, 2020		December 31, 2019		September 30, 2019	
Backlog:						
Mechanical Services	\$ 1,226,146	85.8 %	\$ 1,348,651	84.2 %	\$ 1,312,396	81.6 %
Electrical Services	202,441	14.2 %	253,135	15.8 %	296,601	18.4 %
Total	\$ 1,428,587	100.0 %	\$ 1,601,786	100.0 %	\$ 1,608,997	100.0 %

Backlog as of September 30, 2020 was \$1.43 billion, a 6.7% decrease from June 30, 2020 backlog of \$1.53 billion, and an 11.2% decrease from September 30, 2019 backlog of \$1.61 billion. The sequential backlog decrease was broad-based, and was primarily as a result of completion of project work at two of our Virginia operations (\$27.2 million), one of our Florida operations (\$15.9 million), our Colorado operation (\$10.0 million) and our Wisconsin operation (\$8.2 million). Additionally, we had increased project bookings at one of our Texas operations (\$6.8 million). The year-over-year backlog decrease included a same-store decrease of \$271.1 million, or 16.8% partially offset by the TAS acquisition (\$40.1 million) and the acquisition of the electrical contractor in North Carolina (\$50.6 million). Same-store year-over-year backlog decreased primarily due to completion of project work at Walker (\$141.7 million), our North Carolina operation (\$37.5 million), one of our Texas operations (\$28.8 million) and our Arizona operation (\$21.7 million). Additionally, we had increased project bookings at one of our Indiana operations (\$22.4 million).

Gross Profit—Gross profit increased \$4.5 million, or 3.1%, to \$147.2 million for the third quarter of 2020 as compared to the same period in 2019. The increase included a 2.1% increase related to the TAS and North Carolina electrical contractor acquisitions and a 1.0% increase in same-store activity. The same-store increase in gross profit was primarily due to improvements in project execution at one of our Indiana operations (\$5.3 million) and one of our Tennessee operations (\$2.9 million), partially offset by a decrease at our Arkansas operation (\$2.5 million) compared to the prior year. Additionally, we had increased volumes at one of our Virginia operations (\$4.2 million), offset by a decrease in volumes at Walker (\$7.4 million). As a percentage of revenue, gross profit for the third quarter increased from 20.2% in 2019 to 20.6% in 2020 primarily due to a broad-based improvement in project execution, as discussed above.

Gross profit increased \$40.6 million, or 11.0%, to \$410.0 million for the first nine months of 2020 as compared to the same period in 2019. The increase included a 4.9% increase related to the TAS, North Carolina electrical contractor and Walker acquisitions and a 6.1% increase in same-store activity. The same-store increase in gross profit was primarily due to improvements in project execution at our North Carolina operation (\$14.9 million) and one of our Indiana operations (\$7.0 million), partially offset by a decrease at one of our Florida operations (\$7.0 million) compared to the prior year. Additionally, we had increased volumes at one of our Virginia operations (\$3.2 million). As a percentage of revenue, gross profit for the nine-month period decreased from 19.5% in 2019 to 19.0% in 2020 primarily due to the factors discussed above and lower margins on the Walker acquisition, which was acquired in April 2019. Additionally, preventative and protective actions taken on projects, such as the social distancing and other procedure adjustments caused by COVID-19, negatively impacted margins starting in March 2020.

Selling, General and Administrative Expenses (“SG&A”)—SG&A increased \$0.9 million, or 1.0%, to \$90.9 million for the third quarter of 2020 as compared to 2019. On a same-store basis, excluding amortization expense, SG&A decreased \$3.8 million, or 4.5%. This decrease is primarily due to the reduction in same-store revenue for the period, as well as reductions in travel-related expenses (\$1.2 million) as a result of COVID-19 and lower bad debt expense of \$0.6 million in the third quarter of 2020. These decreases were partially offset by increases in tax consulting fees in the third quarter of 2020 which totaled \$2.8 million, as compared to \$0.9 million in the same period in 2019. Amortization expense increased \$0.8 million during the period, primarily as a result of the TAS and North Carolina electrical contractor acquisitions. As a percentage of revenue, SG&A for the third quarter remained steady at 12.7% in both 2019 and 2020.

SG&A increased \$15.4 million, or 6.1%, to \$268.9 million for the first nine months of 2020 as compared to 2019. On a same-store basis, excluding amortization expense, SG&A decreased \$3.3 million, or 1.4%. This decrease is primarily due to the sale of the majority of the assets and ongoing business of our California operation in the third quarter of 2019 (\$5.0 million) as well as due to a reduction in travel-related expenses as a result of COVID-19 (\$2.8 million). These decreases were partially offset by an increase in bad debt expense of \$2.3 million, mainly driven by concerns about collectability of certain receivables due to the business interruptions caused by COVID-19, specifically with respect to receivables with retail, restaurants and entertainment companies. Furthermore, tax consulting fees increased from \$1.3 million in the first nine months of 2019 to \$2.8 million in the same period in 2020. Amortization expense increased \$3.0 million during the period, primarily as a result of the Walker, TAS and North Carolina electrical contractor acquisitions. As a percentage of revenue, SG&A for the nine-month period decreased from 13.4% in 2019 to 12.5% in 2020 due to the factors discussed above and due to the acquisition of Walker, which has lower SG&A as a percentage of revenue.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2020	2019	2020	2019
	(in thousands)		(in thousands)	
SG&A	\$ 90,888	\$ 90,006	\$ 268,857	\$ 253,417
Less: SG&A from companies acquired	(3,813)	—	(15,730)	—
Less: Amortization expense	(6,889)	(6,065)	(19,596)	(16,575)
Same-store SG&A, excluding amortization expense	\$ 80,186	\$ 83,941	\$ 233,531	\$ 236,842

Interest Expense—Interest expense decreased \$1.0 million, or 37.6%, to \$1.7 million for the third quarter of 2020 as compared to the same period in 2019. The decrease in interest expense is due to a reduction in our average interest rate on our outstanding borrowings in the third quarter of 2020 compared to the prior year. Interest expense remained steady at \$6.9 million for the first nine months of both 2020 and 2019. Increases in borrowings on the senior credit facility and notes to former owners for our recent acquisitions, including TAS, were offset by a reduction in our average interest rate on outstanding borrowings for the first nine months of 2020 as compared to 2019.

Changes in the Fair Value of Contingent Earn-out Obligations—The contingent earn-out obligations are measured at fair value each reporting period, and changes in estimates of fair value are recognized in earnings. Income from changes in the fair value of contingent earn-out obligations for the third quarter of 2020 increased \$5.4 million as compared to the same period in 2019. Income from changes in the fair value of contingent earn-out obligations for the first nine months of 2020 increased \$5.7 million as compared to the same period in 2019. The increases were caused by higher expenses in the prior year as a result of increasing our obligation for the BCH acquisition as earnings exceeded forecast in the prior year as well as a reduction in our obligation for Walker in the current year caused by project delays, the impact of COVID-19 and lower than forecasted earnings in the current quarter.

Provision for Income Taxes—Our provision for income taxes for the nine months ended September 30, 2020 was \$30.1 million with an effective tax rate of 21.9% as compared to a provision for income taxes of \$26.3 million with an effective tax rate of 24.7% for the same period in 2019. The effective tax rate for 2020 was higher than the 21% federal statutory rate primarily due to net state income taxes (4.8%) and nondeductible expenses, including nondeductible expenses related to TAS (2.2%), partially offset by a decrease in unrecognized tax benefits as a result of settlement with the Internal Revenue Service (the “IRS”) upon completion of its examination of our amended federal returns for 2014 and 2015 (6.0%). The effective tax rate for 2019 was higher than the 21% federal statutory rate primarily due to net state income taxes (4.4%) and nondeductible expenses (1.7%) partially offset by benefits from the filing, and expected filing, of amended returns to claim the energy efficient commercial buildings deduction (the “179D deduction”) allocated to us (1.9%) and deductions for stock-based compensation (0.4%).

We currently estimate our effective tax rate for the full year 2020 will be between 22% and 25%, which includes the tax benefits from the IRS settlement of 2014 and 2015 tax years. Starting in 2021, we expect our effective tax rate will be between 25% and 30%, as we cannot reasonably estimate the tax benefits from the credit for increasing research activities (the “R&D tax credit”) or 179D deduction at this time.

Outlook

Industry conditions improved during the four-year period from 2016 to 2019, and at the beginning of 2020 we expected this strong activity to continue during the current year. However, starting at the end of the first quarter of this year, we experienced negative impacts to our business due to the business disruption caused by COVID-19. In March 2020, the World Health Organization categorized COVID-19 as a pandemic, and the United States declared the COVID-19 outbreak a national emergency.

Our service business experienced the first and most pronounced negative impacts, largely because of building closures or decisions by customers to limit building access. As of the end of the third quarter, the majority of our service operations had returned to levels that are at or near normal functioning. Our construction activities have generally been classified as essential services in the substantial majority of our markets, although we have had certain jobs temporarily or partially close due to government action, decisions by owners, or upon positive tests for COVID-19 of workers at various sites. We have experienced delays in the award of new construction work in certain instances, and we have also experienced limited instances of delayed starts. Additionally, we have had some delays or cancellations of work in less than 5% of our backlog. Across our operations we have implemented safety precautions and other COVID-19 related guidelines that have added cost or inefficiency as we work to create a safe environment for our team members and our communities. The Company considered the ongoing impact of COVID-19 on the assumptions and estimates used to determine our results and asset valuations as of September 30, 2020 and determined that there were no material or systematic adverse impacts on the Company’s third quarter except for diminished revenue, operational inefficiency, and adjustments in bad debt expense due to the potential for nonpayment by customers in industries more directly impacted by COVID-19.

At this time, it is impossible to quantify the impact of COVID-19 in the upcoming quarters because we do not know how the pandemic and related governmental decisions will unfold, nor how the pandemic may impact decisions of our customers. The impact of COVID-19 creates more uncertainty than usual in our business outlook, and we currently expect that in some markets we will experience additional delays in the award or commencement of a portion of our projects that is likely to impact activity levels in the coming quarters and particularly during the first half of 2021. Nevertheless, assuming COVID-19 does not materially worsen, we expect that that we will continue to achieve substantial positive earnings and cash flow in the fourth quarter of 2020 and in 2021, and we continue to prepare for a wide range of economic circumstances.

Liquidity and Capital Resources (in thousands):

	Nine Months Ended September 30,	
	2020	2019
Cash provided by (used in):		
Operating activities	\$ 216,400	\$ 99,715
Investing activities	(130,514)	(216,053)
Financing activities	(66,134)	111,081
Net increase (decrease) in cash and cash equivalents	<u>\$ 19,752</u>	<u>\$ (5,257)</u>
Free cash flow:		
Cash provided by operating activities	\$ 216,400	\$ 99,715
Purchases of property and equipment	(19,459)	(22,641)
Proceeds from sales of property and equipment	1,890	1,447
Free cash flow	<u>\$ 198,831</u>	<u>\$ 78,521</u>

Cash Flow

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

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

Cash provided by operating activities was \$216.4 million during the first nine months of 2020 compared with \$99.7 million during the same period in 2019. This increase was primarily driven by a \$65.0 million change in receivables, net driven by strong collections in the current year, an \$18.0 million change in other long-term liabilities, a \$14.0 million change in prepaid expenses and other current assets and an \$8.9 million change in billings in excess of costs, which was driven by timing of payments and project billings. Operating cash flows in the current year benefited by approximately \$20.9 million from the deferral of payroll taxes allowed by the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) that normally would have been paid by September 30, 2020.

Cash Used in Investing Activities—During the first nine months of 2020, cash used in investing activities was \$130.5 million compared to \$216.1 million during the same period in 2019. The \$85.6 million decrease in cash used primarily relates to cash paid (net of cash acquired) for acquisitions in 2020 compared to the same period in 2019.

Cash Provided by (Used in) Financing Activities—Cash used in financing activities was \$66.1 million for the first nine months of 2020 compared to cash provided by financing activities of \$111.1 million during the same period in 2019. The \$177.2 million decrease in cash provided by financing activities is primarily due to a decrease in net proceeds from the debt compared to the prior year, which was driven by stronger operating cash flows in the current year that allowed us to pay down more debt.

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

Share Repurchase Program

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On November 19, 2019, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.8 million shares. Since the inception of the repurchase program, the Board has approved 9.5 million shares to be repurchased. As of September 30, 2020, we have repurchased a cumulative total of 9.1 million shares at an average price of \$18.89 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. In an exercise of such discretion, we suspended share repurchases from March 27, 2020 to May 26, 2020 in response to the uncertainty surrounding the current COVID-19 pandemic, as more fully described in “Item 1A. Risk Factors” herein. The Board may modify, suspend, extend or terminate the program at any time. During the nine months ended September 30, 2020, we repurchased 0.4 million shares for approximately \$18.8 million at an average price of \$41.90 per share.

Debt

Revolving Credit Facility and Term Loan

We have a \$600.0 million senior credit facility (the “Facility”) provided by a syndicate of banks. The Facility is composed of a revolving credit line in the amount of \$450.0 million and a \$150.0 million term loan, and the Facility provides for a \$150.0 million accordion or increase option for the revolving portion of the Facility. The Facility also includes a sublimit of up to \$160.0 million issuable in the form of letters of credit. The Facility expires in January 2025 and is secured by a first lien on substantially all of our personal property except for assets related to projects subject to surety bonds and assets held by certain unrestricted subsidiaries and our wholly owned captive insurance company and a second lien on our assets related to projects subject to surety bonds. In 2019, we incurred approximately \$1.4 million in financing and professional costs in connection with an amendment to the Facility, which are being amortized over the remaining term of the Facility. Of this amount, \$0.4 million is attributable to the term loan and is being amortized using the effective interest method. The remaining \$1.0 million is attributable to the revolving credit line, which combined with the previous unamortized costs of \$1.3 million, is being amortized over the remaining term of the Facility on a straight-line basis as a non-cash charge to interest expense. For the term loan, we are required to make quarterly payments increasing over time from 1.25% to 3.75% of the original aggregate principal amount of the term loan, with the balance due in January 2025. As of September 30, 2020, we had \$61.5 million of outstanding borrowings on the revolving credit facility, \$55.6 million in letters of credit outstanding and \$332.9 million of credit available.

There are two interest rate options for borrowings under the Facility, the Base Rate Loan option and the Eurodollar Rate Loan option. These rates are floating rates determined by the broad financial markets, meaning they can and do move up and down from time to time. Additional margins are then added to these two rates.

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under

those contracts. Our lenders issue such letters of credit through the Facility for a fee. We have never had a claim made against a letter of credit that resulted in payments by a lender or by us and believe such claims are unlikely in the foreseeable future. The letter of credit fees range from 1.25% to 2.00% per annum, based on the ratio of Consolidated Total Indebtedness to “Credit Facility Adjusted EBITDA,” which shall mean Consolidated EBITDA as such term is defined in the credit agreement.

Commitment fees are payable on the portion of the revolving loan capacity not in use for borrowings or letters of credit at any given time. These fees range from 0.20% to 0.35% per annum, based on the ratio of Consolidated Total Indebtedness to Credit Facility Adjusted EBITDA.

The Facility contains financial covenants defining various financial measures and the levels of these measures with which we must comply. Covenant compliance is assessed as of each quarter end.

The Facility’s principal financial covenants include:

Total Leverage Ratio—The Facility requires that the ratio of our Consolidated Total Indebtedness to our Credit Facility Adjusted EBITDA not exceed 3.00 to 1.00 as of the end of each fiscal quarter. The total leverage ratio as of September 30, 2020 was 0.8.

Fixed Charge Coverage Ratio—The Facility requires that the ratio of (a) Credit Facility Adjusted EBITDA, less non-financed capital expenditures, provision for income taxes, dividends, and amounts used to repurchase stock when the Company’s Total Leverage Ratio exceeds 2.00 to 1.00, to (b) the sum of interest expense and scheduled principal payments of indebtedness be at least 1.50 to 1.00. Credit Facility Adjusted EBITDA, capital expenditures, provision for income taxes, dividends, stock repurchase payments, interest expense, and scheduled principal payments are defined under the Facility for purposes of this covenant, to be amounts for the four quarters ending as of any given quarterly covenant compliance measurement date. The fixed charge coverage ratio as of September 30, 2020 was 6.6.

Other Restrictions—The Facility permits acquisitions of up to \$5.0 million per transaction, provided that the aggregate purchase price of such an acquisition and of acquisitions in the same fiscal year does not exceed \$10.0 million. However, these limitations only apply when the Company’s Total Leverage Ratio is greater than 2.50 to 1.00.

While the Facility’s financial covenants do not specifically govern capacity under the Facility, if our debt level under the Facility at a quarter-end covenant compliance measurement date were to cause us to violate the Facility’s leverage ratio covenant, our borrowing capacity under the Facility and the favorable terms that we currently have could be negatively impacted by the lenders.

We were in compliance with all of our financial covenants as of September 30, 2020.

Notes to Former Owners

As part of the consideration used to acquire four companies, we have outstanding notes to the former owners. These notes had an outstanding balance of \$26.1 million as of September 30, 2020. In conjunction with the acquisition of TAS in the second quarter of 2020, we issued a promissory note to former owners with an outstanding balance of \$8.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.5%. The principal is due in April 2022. In conjunction with the acquisition of the electrical contractor in North Carolina in the first quarter of 2020, we issued a promissory note to former owners with an outstanding balance of \$8.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.0%. The principal is due in equal installments in February 2023 and February 2024. In conjunction with the Walker acquisition in the second quarter of 2019, we issued a promissory note to former owners with an outstanding balance of \$10.0 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 4.0%. The principal is due in April 2023. In conjunction with one immaterial acquisition in 2019, we issued a note to former owners with an outstanding balance of \$0.1 million as of September 30, 2020 that bears interest, payable quarterly, at a stated interest rate of 3.0%. The principal is due in January 2021.

Outlook

We have generated positive net free cash flow for the last twenty-one calendar years, much of which occurred during challenging economic and industry conditions. We also continue to have significant borrowing capacity under our credit facility, and we maintain what we feel are reasonable cash balances. We believe these factors will provide us with sufficient liquidity to fund our operations for the foreseeable future.

Off-Balance Sheet Arrangements and Other Commitments

Certain of our vendors require letters of credit to ensure reimbursement for amounts they are disbursing on our behalf, such as to beneficiaries under our self-funded insurance programs. We have also occasionally used letters of credit to guarantee performance under our contracts and to ensure payment to our subcontractors and vendors under those contracts. The letters of credit we provide are actually issued by our lenders through the Facility as described above. A letter of credit commits the lenders to pay specified amounts to the holder of the letter of credit if the holder demonstrates that we have failed to perform specified actions. If this were to occur, we would be required to reimburse the lenders. Depending on the circumstances of such a reimbursement, we may also have to record a charge to earnings for the reimbursement. Absent a claim, there is no payment or reserving of funds by us in connection with a letter of credit. However, because a claim on a letter of credit would require immediate reimbursement by us to our lenders, letters of credit are treated as a use of the Facility's capacity just the same as actual borrowings. Claims against letters of credit are rare in our industry. To date, we have not had a claim made against a letter of credit that resulted in payments by a lender or by us. We believe that it is unlikely that we will have to fund claims under a letter of credit in the foreseeable future.

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

Under standard terms in the surety market, sureties issue bonds on a project-by-project basis, and can decline to issue bonds at any time. Historically, approximately 15% to 25% of our business has required bonds. While we currently have strong surety relationships to support our bonding needs, future market conditions or changes in our sureties' assessment of our operating and financial risk could cause our sureties to decline to issue bonds for our work. If that were to occur, our alternatives include doing more business that does not require bonds, posting other forms of collateral for project performance, such as letters of credit or cash, and seeking bonding capacity from other sureties. We would likely also encounter concerns from customers, suppliers and other market participants as to our creditworthiness. While we believe our general operating and financial characteristics would enable us to ultimately respond effectively to an interruption in the availability of bonding capacity, such an interruption would likely cause our revenue and profits to decline in the near term.

Contractual Obligations

As of September 30, 2020, we have \$55.6 million in letter of credit commitments, of which \$14.8 million will expire in 2020 and \$40.8 million will expire in 2021. The substantial majority of these letters of credit are posted with insurers who disburse funds on our behalf in connection with our workers' compensation, auto liability and general liability insurance program. These letters of credit provide additional security to the insurers that sufficient financial resources will be available to fund claims on our behalf, many of which develop over long periods of time, should we ever encounter financial duress. Posting of letters of credit for this purpose is a common practice for entities that manage their self-insurance programs through third-party insurers as we do. While many of these letter of credit commitments expire in the next twelve months, we expect nearly all of them, particularly those supporting our insurance programs, will be renewed annually.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to market risk primarily related to potential adverse changes in interest rates, as discussed below. We are actively involved in monitoring exposure to market risk and continue to develop and utilize appropriate risk management techniques. We are not exposed to any other significant financial market risks, including commodity price risk, or foreign currency exchange risk from the use of derivative financial instruments. At times, we use derivative financial instruments to manage our interest rate risk.

We have exposure to changes in interest rates under our senior credit facility. Our debt with fixed interest rates consists of notes to former owners of acquired companies.

The weighted average interest rate applicable to the borrowings under the revolving credit facility was approximately 1.4% as of September 30, 2020. The weighted average interest rate applicable to the term loan was approximately 1.4% as of September 30, 2020.

We measure certain assets at fair value on a nonrecurring basis. These assets are recognized at fair value when they are deemed to be other-than-temporarily impaired. We did not recognize any impairments in the current year on those assets required to be measured at fair value on a nonrecurring basis.

The valuation of the Company's contingent earn-out payments is determined using a probability weighted discounted cash flow method. This analysis reflects the contractual terms of the purchase agreements (e.g., minimum and maximum payment, length of earn-out periods, manner of calculating any amounts due, etc.) and utilizes assumptions with regard to future cash flows, probabilities of achieving such future cash flows and a discount rate.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

Changes in Internal Control over Financial Reporting

There have not been any changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the three months ended September 30, 2020 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part 1, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2019, which could materially affect our business, financial condition, or future results. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition, or future results. Except as updated below, there were no material changes from the risk factors disclosed in Part 1, “Item 1A. Risk Factors” in our Annual Report on Form 10-K for the year ended December 31, 2019.

The Company’s business has been and may continue to be negatively affected by health crises or outbreaks of disease, such as epidemics or pandemics, including the ongoing COVID-19 pandemic.

The Company’s operations have and continue to be affected by the ongoing global COVID-19 pandemic (the “virus”), which was declared a “pandemic” by the World Health Organization in March 2020, and the resulting volatility and uncertainty it has caused in the U.S. and other markets. The full impact of COVID-19 is unknown and rapidly evolving; the pandemic could result in a prolonged economic downturn and has disrupted, and may continue to disrupt, the Company’s business. The outbreak and any preventative or protective actions that the Company or its customers, suppliers, vendors and other third parties may take in respect of this virus, including those required by regulatory authorities, have and may continue to result in a period of disruption. The Company cannot reasonably estimate the length or severity of the COVID-19 pandemic or the related response, or the extent to which the disruption may materially impact the Company’s business, financial position, results of operations, cash flows and liquidity.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Recent Sales of Unregistered Securities

None.

Issuer Purchases of Equity Securities

On March 29, 2007, our Board of Directors (the “Board”) approved a stock repurchase program to acquire up to 1.0 million shares of our outstanding common stock. Subsequently, the Board has from time to time increased the number of shares that may be acquired under the program and approved extensions of the program. On November 19, 2019, the Board approved an extension to the program by increasing the shares authorized for repurchase by 0.8 million shares. Since the inception of the repurchase program, the Board has approved 9.5 million shares to be repurchased. As of September 30, 2020, we have repurchased a cumulative total of 9.1 million shares at an average price of \$18.89 per share under the repurchase program.

The share repurchases will be made from time to time at our discretion in the open market or privately negotiated transactions, as permitted by securities laws and other legal requirements, and subject to market conditions and other factors. In an exercise of such discretion, we suspended share repurchases from March 27, 2020 to May 26, 2020 in response to the uncertainty surrounding the current COVID-19 pandemic, as more fully described in “Item 1A. Risk Factors” herein. The Board may modify, suspend, extend or terminate the program at any time. During the nine months ended September 30, 2020, we repurchased 0.4 million shares for approximately \$18.8 million at an average price of \$41.90 per share.

During the quarter ended September 30, 2020, we purchased our common shares in the following amounts at the following average prices:

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1)	Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
July 1 - July 31	24,455	\$ 39.22	8,942,172	605,997
August 1 - August 31	23,966	\$ 51.00	8,966,138	582,031
September 1 - September 30	109,387	\$ 51.10	9,075,525	472,644
	<u>157,808</u>	<u>\$ 49.24</u>	<u>9,075,525</u>	<u>472,644</u>

- (1) Purchased as part of a program announced on March 29, 2007 under which, since the inception of this program, 9.5 million shares have been approved for repurchase.

Under our 2012 Equity Incentive Plan and 2017 Omnibus Incentive Plan, employees may elect to have us withhold common shares to satisfy statutory federal, state and local tax withholding obligations arising on the vesting of restricted stock awards and exercise of options. When we withhold these shares, we are required to remit to the appropriate taxing authorities the market price of the shares withheld, which could be deemed a purchase of the common shares by us on the date of withholding.

Item 6. Exhibits

Exhibit Number	Description of Exhibits	Incorporated by Reference to the Exhibit Indicated Below and to the Filing with the Commission Indicated Below	
		Exhibit Number	Filing or File Number
3.1	Second Amended and Restated Certificate of Incorporation of the Registrant	3.1	333-24021
3.2	Certificate of Amendment dated May 21, 1998	3.2	1998 Form 10-K
3.3	Certificate of Amendment dated July 9, 2003	3.3	2003 Form 10-K
3.4	Certificate of Amendment dated May 20, 2016	3.1	May 20, 2016 Form 8-K
3.5	Amended and Restated Bylaws of Comfort Systems USA, Inc.	3.1	March 25, 2016 Form 8-K
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002		
32.1**	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		
32.2**	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002		
101.INS*	Inline XBRL Instance Document		
101.SCH*	Inline XBRL Taxonomy Extension Schema Document		
101.CAL*	Inline XBRL Taxonomy Extension Calculation Linkbase Document		
101.DEF*	Inline XBRL Taxonomy Extension Definition Linkbase Document		
101.LAB*	Inline XBRL Taxonomy Extension Label Linkbase Document		
101.PRE*	Inline XBRL Taxonomy Extension Presentation Linkbase Document		
104	Cover Page Interactive Data File (the cover page XBRL tags are embedded in the Inline XBRL document)		

* Filed herewith.

** Furnished herewith.

SIGNATURES

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

COMFORT SYSTEMS USA, INC.

October 26, 2020

By: /s/ BRIAN E. LANE
 Brian E. Lane
 President, Chief Executive Officer and Director

October 26, 2020

By: /s/ WILLIAM GEORGE
 William George
 Executive Vice President and Chief Financial Officer

October 26, 2020

By: /s/ JULIE S. SHAEFF
 Julie S. Shaeff
 Senior Vice President and Chief Accounting Officer

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
Pursuant to Section 302 of the Sarbanes Oxley Act of 2002**

I, Brian E. Lane, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Comfort Systems USA, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2020

/s/ BRIAN E. LANE

Brian E. Lane

President and Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002**

I, William George, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Comfort Systems USA, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a. designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b. designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c. evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d. disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - a. all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: October 26, 2020

/s/ WILLIAM GEORGE

William George

Executive Vice President and Chief Financial Officer

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

In connection with the Quarterly Report of Comfort Systems USA, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Brian E. Lane, President and Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: October 26, 2020

/s/ BRIAN E. LANE

Brian E. Lane

President and Chief Executive Officer

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.

**CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002***

In connection with the Quarterly Report of Comfort Systems USA, Inc. (the "Company") on Form 10-Q for the quarter ended September 30, 2020, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, William George, Executive Vice President and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d), as applicable, of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and result of operations of the Company.

Date: October 26, 2020

/s/ WILLIAM GEORGE

William George

Executive Vice President and Chief Financial Officer

* A signed original of this written statement required by Section 906 has been provided to the Company and will be retained by the Company and furnished to the Securities and Exchange Commission or its staff upon request.
