

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

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 JUNE 30, 2001

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM TO

COMMISSION FILE NUMBER: 1-13011

COMFORT SYSTEMS USA, INC.
(Exact name of registrant as specified in its charter)

DELAWARE
(State or other jurisdiction
of incorporation or organization)

76-0526487
(I.R.S. Employer
Identification No.)

777 POST OAK BOULEVARD
SUITE 500
HOUSTON, TEXAS 77056
(Address of Principal Executive Offices) (Zip Code)

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

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

The number of shares outstanding of the issuer's common stock, as of August
10, 2001, was 37,380,773.

COMFORT SYSTEMS USA, INC.

INDEX TO FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2001

PAGE ---- PART I -- FINANCIAL INFORMATION Item 1 --
 Financial Statements COMFORT SYSTEMS USA, INC.
 Consolidated Balance Sheets..... 1
 Consolidated Statements of Operations..... 2
 Consolidated Statements of Stockholders' Equity..... 3
 Consolidated Statements of Cash Flows..... 4
 Condensed Notes to Consolidated Financial
 Statements..... 5
 Item 2 -- Management's Discussion and Analysis of
 Financial Condition and Results of Operations.....
 12 Item 3 -- Quantitative and Qualitative Disclosures
 about Market
 Risk..... 16 PART
 II -- OTHER INFORMATION Item 1 -- Legal
 Proceedings..... 17 Item 2 --
 Recent Sales of Unregistered Securities..... 17 Item
 6 -- Exhibits and Reports on Form 8-K..... 17
 Item 9 -- Changes and Disagreements with Accountants on
 Accounting and Financial Disclosure.....
 17
 Signature.....
 18

COMFORT SYSTEMS USA, INC.

CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

DECEMBER 31, JUNE 30, 2000	2001	-----
(UNAUDITED) ASSETS CURRENT ASSETS: Cash and cash equivalents..... \$ 16,021 \$ 17,152		
Accounts receivable, less allowance of \$6,789 and \$8,549.....	334,152	325,839
receivables.....	5,879	4,978
Inventories.....	19,399	18,957
other.....	10,568	8,885
and estimated earnings in excess of billings.....	44,078	46,618
sale.....	3,197	2,086
-----	-----	-----
assets.....	433,294	424,515
PROPERTY AND EQUIPMENT,		
net.....	40,085	37,193
GOODWILL, less accumulated amortization of \$32,904 and \$38,728.....	450,493	444,469
OTHER NONCURRENT		
ASSETS.....	2,538	3,018
-----	-----	-----
assets.....	\$926,410	\$909,195
=====	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY CURRENT LIABILITIES: Current maturities of long-term debt..... \$ 216 \$ 107		
maturities of notes to affiliates and former owners.....	8,850	6,067
Accounts payable.....	114,613	110,253
Accrued compensation and benefits.....	40,880	37,850
Billings in excess of costs and estimated earnings.....	68,574	79,775
Other current liabilities.....	26,942	30,393
-----	-----	-----
liabilities.....	260,075	264,445
LONG-TERM DEBT, NET OF CURRENT MATURITIES.....		
224,111	200,344	NOTES TO AFFILIATES AND FORMER OWNERS, NET OF CURRENT MATURITIES.....
41,424	38,067	DEFERRED INCOME
TAXES.....	952	OTHER
LONG-TERM LIABILITIES.....	561	566
-----	-----	-----
liabilities.....	526,171	504,374
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, 39,258,913 shares issued.....	393	393
Treasury stock, at cost, 2,002,629 and 1,878,140 shares, respectively.....	(13,119)	(11,728)
Additional paid-in capital.....	341,923	340,723
Retained earnings.....	71,042	75,433
-----	-----	-----
Total stockholders' equity.....	400,239	404,821
-----	-----	-----
Total liabilities and stockholders' equity.....	\$926,410	\$909,195
=====	=====	=====

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		SIX MONTHS ENDED		JUNE 30,	
	2000	2001	2000	2001	2000	2001
REVENUES.....	\$404,970	\$392,141	\$767,536	\$760,269	COST OF SERVICES.....	
	334,332	323,070	626,031	627,301	-----	
	----- Gross					
profit.....	70,638	69,071	SELLING, GENERAL AND ADMINISTRATIVE EXPENSES.....			
	141,505	132,968	56,333	53,001	-----	
	----- Goodwill					
AMORTIZATION.....	3,149	RESTRUCTURING CHARGES.....				
	3,021	6,332	6,042	354	--	354
	238	-----				
Operating income.....	10,802	OTHER INCOME (EXPENSE):				
	13,049	23,658	21,193	Interest income.....		
	----- Interest					
expense.....	(6,681)	Other.....				
	(6,476)	(12,778)	(12,705)	-----		
	(12)	230	90	374	-----	
	--- Other income (expense).....					
	(6,486)	(6,222)	(12,310)	(12,263)	-----	
	--- REDUCTIONS IN NON-OPERATING ASSETS AND LIABILITIES,					
NET.....	(5,190)	INCOME (LOSS) BEFORE INCOME TAXES.....				
	(5,190)	(874)	6,827	6,158	8,930	-----
	----- INCOME TAX EXPENSE.....					
	31	3,536	NET INCOME			
	3,055	4,539	-----			
(LOSS).....	\$ (905)	NET INCOME (LOSS) PER SHARE:				
3,291	\$ 3,103	\$ 4,391	=====	=====	=====	=====
	===== NET INCOME (LOSS) PER SHARE:					
Basic.....	\$ (0.02)	\$ 0.09	\$ 0.08	\$ 0.12	=====	=====
	=====					
Diluted.....	\$ (0.02)	\$ 0.09	\$ 0.08	\$ 0.12	=====	=====
	===== SHARES USED IN COMPUTING NET INCOME (LOSS) PER SHARE:					
Basic.....	37,496	37,381	37,528	37,383	=====	=====
	=====					
Diluted.....	37,496	37,431	37,538	37,389	=====	=====
	=====					

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

COMFORT SYSTEMS USA, INC.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

COMMON STOCK	TREASURY STOCK		
ADDITIONAL TOTAL	-----		
-----	-----		
PAID-IN RETAINED STOCKHOLDERS'			
SHARES AMOUNT	SHARES AMOUNT		
CAPITAL EARNINGS EQUITY	-----		
-----	-----		
-- BALANCE AT DECEMBER 31,			
1999.....	39,258,913	\$393	
(1,695,524)	\$(11,978)	\$342,655	
\$87,895	\$418,965	Issuance of	
Common Stock: Issuance of			
Employee Stock Purchase Plan			
shares.....	-- --	329,212	
2,254 (732)	--	1,522	Common
Stock repurchases.....	-- --		
(175,513)	(1,224)	-- --	(1,224)
Shares exchanged in repayment			
of notes			
receivable.....	-- --		
(385,996)	(1,975)	-- --	(1,975)
Shares received from sale of			
businesses.....			
-- --	(74,808)	(196)	-- --
(196)	Net		
loss.....	-- --		
-- --	(16,853)	(16,853)	--
-----	-----		
BALANCE AT DECEMBER 31,			
2000.....	39,258,913	393	
(2,002,629)	(13,119)	341,923	
71,042	400,239	Issuance of	
Common Stock: Issuance of			
Employee Stock Purchase Plan			
shares			
(unaudited).....	-- --		
- 269,481	1,766	(1,200)	-- 566
Shares received from sale of			
businesses (unaudited).....			
-- --	(144,992)	(375)	-- --
(375)	Net income		
(unaudited).....	-- --		
-- --	4,391	4,391	-----
-----	-----		
BALANCE AT			
JUNE 30, 2001			
(unaudited).....			
39,258,913	\$393	(1,878,140)	
\$(11,728)	\$340,723	\$75,433	
\$404,821	=====	=====	
=====	=====	=====	
=====	=====		

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

COMFORT SYSTEMS USA, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

SIX MONTHS ENDED JUNE 30, -----	2000	2001	-----	CASH FLOWS FROM
				OPERATING ACTIVITIES: Net
income.....				
\$ 3,103	\$ 4,391			Adjustments to reconcile net income
				to net cash provided by operating activities --
				Restructuring
charges.....			354 238	
				Depreciation and amortization
expense.....	12,191	11,942		Bad debt
expense.....			1,875	
	2,783			Deferred tax
expense.....			203 2,449	
				Gain on sale of property and
equipment.....	(156)	(129)		Reduction in
				non-operating assets and liabilities,
net.....				
5,190	--			Changes in operating assets and liabilities
	--			(Increase) decrease in -- Receivables,
net.....			(40,570) 6,069	
				Inventories.....
	194	112		Prepaid expenses and other current
assets.....	4,649	1,075		Costs and estimated
				earnings in excess of
billings.....				
	1,898	(1,834)		Other noncurrent
assets.....			927 (1,069)	
				Increase (decrease) in -- Accounts payable and
accrued liabilities.....	10,559	(4,839)		Billings
				in excess of costs and estimated
earnings.....				
	17,605	11,229		Other,
net.....			(524)	
(411)	-----	-----		Net cash provided by
operating activities.....	17,498	32,006	-----	
				CASH FLOWS FROM INVESTING ACTIVITIES:
				Purchases of property and
equipment.....			(9,430) (3,148)	
				Proceeds from sales of property and
equipment.....	485	354		Proceeds from
businesses sold.....			-- 954	
				Net cash used in investing
activities.....	(8,945)	(1,840)	-----	
				CASH FLOWS FROM FINANCING ACTIVITIES: Payments
on long-term debt.....				
	(148,519)	(130,310)		Borrowings of long-term
debt.....			145,666 100,709	
				Proceeds from issuance of common
stock.....	762	566		Repurchases of
common stock.....			(1,224)	
				Net cash used in financing
activities.....	(3,315)	(29,035)	-----	
				NET INCREASE IN CASH AND CASH
EQUIVALENTS.....	5,238	1,131		CASH AND
CASH EQUIVALENTS, beginning of period.....	3,664	16,021		CASH AND CASH
				EQUIVALENTS, end of period..... \$
	8,902	\$ 17,152	=====	=====

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

COMFORT SYSTEMS USA, INC.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
JUNE 30, 2001
(UNAUDITED)

1. BUSINESS AND ORGANIZATION:

Comfort Systems USA, Inc., a Delaware corporation ("Comfort Systems" and collectively with its subsidiaries, the "Company"), is a leading national provider of comprehensive heating, ventilation and air conditioning ("HVAC") installation, maintenance, repair and replacement services. The Company operates primarily in the commercial and industrial HVAC markets, and performs most of its services within manufacturing plants, office buildings, retail centers, apartment complexes, and healthcare, education and government facilities. In addition to standard HVAC services, the Company provides specialized applications such as process cooling, building automation control systems, electronic monitoring and process piping. Certain locations also perform related services such as electrical and plumbing.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES:

Basis of Presentation

These interim statements should be read in conjunction with the historical Consolidated Financial Statements and related notes of Comfort Systems included in the Annual Report on Form 10-K as filed with the Securities and Exchange Commission for the year ended December 31, 2000 (the "Form 10-K").

There were no significant changes in the accounting policies of the Company during the periods presented. For a description of the significant accounting policies of the Company, refer to Note 2 of Notes to Consolidated Financial Statements of Comfort Systems included in the 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. Accordingly, these financial statements do not include all information or footnotes required by generally accepted accounting principles for complete financial statements and should be read in conjunction with the Form 10-K. The Company believes all adjustments necessary for a fair presentation of these interim statements have been included and are of a normal and recurring nature. The results of operations for interim periods are not necessarily indicative of the results for the fiscal year.

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, disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Cash Flow Information

Cash paid for interest for the six months ended June 30, 2000 and 2001 was approximately \$11.9 million and \$11.6 million, respectively. Cash paid for income taxes for the six months ended June 30, 2000 and 2001 was approximately \$10.8 million and \$2.1 million, respectively.

Accounting Pronouncements

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 141 also specifies criteria for recording intangible assets other than goodwill in connection with business combinations. SFAS No. 142 requires companies to assess goodwill assets for impairment each year, and more frequently if circumstances suggest an

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

impairment may have occurred. SFAS No. 142 also introduces a more stringent framework for assessing goodwill impairment than the approach required under existing rules. In addition, SFAS No. 142 discontinues the regular charge, or amortization, of goodwill assets against income.

SFAS No. 141 is effective immediately. SFAS No. 142 is effective for the Company beginning January 1, 2002 and early adoption is not allowed for calendar year companies. Any impairment loss recognized in accordance with SFAS No. 142 will be shown as the cumulative effect of a change in accounting principle in the Company's income statement. Under this treatment, the Company's income statement would show after-tax results of operations both with and without the cumulative effect of the change in accounting principle recognizing an impairment.

The Company is currently reviewing these new accounting standards. Under existing standards, the Company recognizes a non-cash charge of approximately \$3 million per quarter in its income statement to amortize its goodwill assets over 40-year lives. This amortization will be discontinued beginning on January 1, 2002 under the new standards. In connection with this change, the Company also expects it will report a lower effective tax rate, since the portion of goodwill amortization that is nondeductible for tax purposes has been the principal item resulting in the excess of the Company's effective tax rate in its income statement over statutory tax rates.

The new requirements for assessing whether these goodwill assets have been impaired involve market-based information that may change prior to the new rules' effective date of January 1, 2002, and as noted above, early adoption is not allowed for the Company. As a result, the Company cannot yet determine whether it will have to recognize a goodwill impairment when the new rules become effective. However, based on a preliminary review of the new standards, and based on currently available information, the Company believes it is likely that it will have to record a non-cash goodwill impairment charge, and that the amount of that charge will be significant in relation to the Company's unamortized goodwill balance, which is expected to be approximately \$438 million at December 31, 2001. If such a charge is necessary, the Company anticipates it would be recorded in the first quarter of 2002 when the new standards become effective. As noted above, if an impairment charge is recorded upon transition to the new standards, it will be reflected as the cumulative effect of a change in accounting principle.

The Company has specifically provided for the possibility of a non-cash goodwill impairment charge in its lending agreements with its banks, and accordingly expects no impact on its current bank credit facility if recognition of such an impairment charge becomes necessary.

In June 1998, the FASB issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." This standard requires entities to recognize all derivative instruments (including certain derivative instruments embedded in other contracts) as assets or liabilities in its balance sheet and measure them at fair value. The statement requires that changes in the derivatives' fair value be recognized currently in earnings unless specific hedge accounting criteria are met. The Company adopted this standard effective January 1, 2001 and there was no impact as the Company does not currently hold or trade derivative instruments.

Reclassifications

Certain reclassifications have been made in prior period financial statements to conform to current period presentation.

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

3. RESTRUCTURING CHARGES:

During the first quarter of 2001, the Company recorded restructuring charges of approximately \$0.2 million, primarily related to contractual severance obligations of two operating presidents in connection with the Company's significant restructuring program undertaken in the second half of 2000. These restructuring charges are net of a gain of approximately \$0.1 million related to management's decision to sell a small operation during the first quarter of 2001.

During the second quarter of 2000, the Company recorded restructuring charges of approximately \$0.4 million, primarily in connection with severance costs related to the departure of the Company's former chief executive officer. During the remainder of fiscal 2000, the Company recorded restructuring charges of approximately \$24.9 million primarily associated with restructuring efforts at certain underperforming operations and its decision to cease its e-commerce activities at Outbound Services, a subsidiary of the Company. As announced by the Company in the third quarter of 2000, management performed an extensive review of its operations during the second half of 2000. As part of this review, management decided to cease operating at three locations, sell five operations (including two smaller satellite operations), and merge two companies into other operations. These actions are substantially complete except that the Company is seeking buyers for two operations it is holding for sale. The Company anticipates that these operations will be sold during 2001. The restructuring charges were primarily non-cash and included goodwill impairments of approximately \$11.5 million and the writedown of other long-lived assets of approximately \$8.5 million. The remaining restructuring items primarily include severance and lease termination costs.

Severance costs recorded in 2000 and 2001 relate to the termination of 147 employees (all of these employees had been terminated as of June 30, 2001) including certain corporate personnel and the management and employees of certain underperforming locations, and to the departure of the Company's former chief executive officer. The following table shows the remaining liabilities associated with the cash portion of the restructuring charges as of June 30, 2001 (in thousands):

	BALANCE AT 2001	BALANCE AT ADDITIONS	JANUARY 1, PAYMENTS	JUNE 30, 2001
Severance.....	\$1,218	\$350	\$(873)	\$695
Lease termination costs and other.....	2,312	--	(1,267)	1,045
Total.....	\$350	\$(2,140)	\$1,740	=====

Aggregated financial information related to the operations addressed by restructuring is as follows (in thousands):

	SIX MONTHS ENDED JUNE 30,	2000	2001
Revenues.....	\$31,033	\$6,636	Operating
loss.....			\$(9,125)
		\$(1,719)	

As of June 30, 2001, net assets held for sale are comprised of the following (in thousands):

Current assets (primarily accounts receivable).....	\$ 4,053
Long-term assets.....	3
Current liabilities (primarily accounts payable and billings in excess of costs and estimated earnings).....	(1,951)
Long-term liabilities.....	(19)
Total.....	=====
	\$ 2,086

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

The restructuring charges recorded in fiscal 2000 associated with the operations that were held for sale at June 30, 2001 were \$3.7 million and primarily related to impairments of goodwill and other long-lived assets based upon the estimated proceeds from the anticipated sale of these operations.

4. REDUCTIONS IN NON-OPERATING ASSETS AND LIABILITIES, NET:

During the quarter ended June 30, 2000, the Company recorded a non-cash charge of approximately \$5.2 million primarily related to the impairment of certain non-operating assets, principally notes receivable from former owners of businesses acquired by the Company. In addition, the Company recorded an impairment of approximately \$0.8 million to its minority investment in two entities associated with the distribution and implementation of high-end engineering and design software. The Company also recorded a gain of approximately \$0.6 million on the reduction of its subordinated note payable to a former owner in connection with the settlement of claims with this former owner.

5. LONG-TERM DEBT OBLIGATIONS:

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

DECEMBER 31,	JUNE 30,	2000	2001	-----	-----
				(UNAUDITED)	Revolving credit
facility.....				\$223,700	
				\$200,000	Notes to affiliates and former
owners.....				50,274	44,134
Other.....				627	451
				-----	-----
				debt.....	274,601
244,585				Less: current maturities.....	
9,066	6,174	-----	-----	\$265,535	\$238,411
				=====	=====

Revolving Credit Facility

The Company amended its revolving credit facility (the "Credit Facility" or the "Facility") provided by Bank One, Texas, N.A. ("Bank One") and other banks (the "Bank Group") in March 2001. As amended, the Credit Facility provides the Company with a revolving line of credit of up to the lesser of \$270 million or 80% of net accounts receivable. The Facility decreases to the lesser of \$250 million or 80% of net accounts receivable as of December 31, 2001, and to the lesser of \$240 million or 80% of net accounts receivable as of June 30, 2002. Borrowings under the Facility are secured by accounts receivable, inventory, fixed assets other than real estate, and the shares of capital stock of the Company's subsidiaries. The Credit Facility expires on January 1, 2003, at which time all amounts outstanding are due.

The Company has a choice of two interest rate options under the Facility. Under one option, the interest rate is determined based on the higher of the Federal Funds Rate plus 0.5% or Bank One's prime rate. An additional margin of 1% to 2% is then added to the higher of these two rates. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate London Interbank Offered Rates or "LIBOR") plus 2.5% to 3.5%. The additional margin for both options depends on the ratio of the Company's debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"), as defined. Commitment fees of 0.375% to 0.5% per annum, also depending on the ratio of debt to EBITDA, are payable on the unused portion of the Facility.

The Credit Facility prohibits payment of dividends and the repurchase of shares by the Company, limits certain non-Bank Group debt, and restricts outlays of cash by the Company relating to certain investments, capital expenditures, vehicle leases, acquisitions and subordinate debt. The Credit Facility also provides for

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

the maintenance of certain levels of shareholder equity and EBITDA, and for the maintenance of certain ratios of the Company's EBITDA to interest expense and debt to EBITDA.

Under the terms of the Credit Facility that were in effect as of June 30 and September 30, 2000, the Company was in violation of certain of the Facility's financial balance and ratio requirements. The Bank Group waived these violations. The Facility's current restrictions and financial balance and ratio requirements generally reflect tighter restrictions, greater specificity and smaller allowable variances on most financial balances and ratios than is typical for such agreements due to the Company's weaker results in 2000. The Facility's current requirements also call for higher levels of EBITDA and lower ratios of debt to EBITDA in the second half of this year than the Company has achieved in recent quarters. While management believes its restructuring efforts and operating strategies along with general market conditions in the commercial/industrial HVAC and building automation controls industry will enable the Company to meet the Facility's requirements, there can be no assurance that the Company will be successful in doing so. Management intends to seek more flexible terms under its borrowing relationships as its results and credit market conditions allow.

As of June 30, 2001, the Company had \$200.0 million in borrowings outstanding under the Credit Facility and had incurred interest expense at an average rate of approximately 9.1% per annum for the first six months of 2001. The Credit Facility's interest rate terms as summarized above are effective as of March 22, 2001 and currently result in an all-in floating interest rate under the Facility's LIBOR option of approximately 7.7%. As of June 30, 2001, the Company also had \$2.3 million in letters of credit outstanding under the Facility, and unused borrowing capacity under the Facility of \$63.5 million. As of August 10, 2001, \$205.0 million in borrowings and \$2.3 million in letters of credit were outstanding under the Facility, and \$58.5 million in unused capacity was available.

Notes to Affiliates and Former Owners

Subordinated notes were issued to former owners of certain purchased companies as part of the consideration used to acquire their companies. These notes had an outstanding balance of \$44.1 million as of June 30, 2001. These notes bear interest, payable quarterly, at a weighted average interest rate of 9.73%. In addition, \$0.6 million of these notes are convertible by the holders into shares of the Company's common stock ("Common Stock") at a weighted average price of \$24.25 per share.

As a result of the Company's covenant violations in 2000 under the Credit Facility, the Bank Group required that originally scheduled principal payments to subordinate debt holders be suspended. This requirement took effect in October 2000. The holders of the Company's subordinate debt generally must wait one year from any payment defaults to pursue collection remedies against the Company. In March 2001, the Company entered into amended agreements with subordinate debt holders representing \$46.3 million in principal, including all the principal originally scheduled to be paid through 2001. These amended agreements allow for partial payments against certain originally scheduled payment amounts, defer remaining principal balances to April 2003, and increase the interest rate on this debt to 10% per annum, payable quarterly. Under these amended agreements, \$6.4 million of principal has been paid from April 1, 2001 to August 10, 2001. The amended agreements also cured all defaults that arose from the suspension of principal payments to subordinate debt holders that began in October 2000. As a result of these amended agreements, the Company's annual maturities of subordinate debt are now \$3.1 million for the remainder of 2001, \$3.6 million in 2002, and \$37.4 million in 2003.

Other Long-Term Obligation Disclosures

The Company anticipates that available borrowings under its Credit Facility and cash flow from operations will be sufficient to meet the Company's normal working capital and capital expenditure needs. As noted above, the Company has agreed to relatively tight restrictions under the Credit Facility. If the Company

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS -- (CONTINUED)

violates any of these restrictions, it will be required to negotiate new terms with its banks. There can be no assurance that in that event, the Company will receive satisfactory new terms from its banks, or that if the Company needs additional financing, that such financing can be secured when needed or on terms the Company deems acceptable.

6. COMMITMENTS AND CONTINGENCIES:

Claims and Lawsuits

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

Self-Insurance

The Company retains the risk for worker's compensation, employer's liability, auto liability, general liability and employee group health claims resulting from uninsured deductibles per accident or occurrence. Losses up to the deductible amounts are accrued based upon the Company's known claims incurred and an estimate of claims incurred but not reported. The accruals are based upon known facts and historical trends, and management believes such accruals to be adequate. A wholly owned insurance company subsidiary reinsures a portion of the risk associated with surety bonds issued by a third party insurance company. Because no claims have been made against these financial instruments in the past, management does not expect these instruments will have a material effect on the Company's consolidated financial statements.

7. STOCKHOLDERS' EQUITY:

Treasury Stock

On October 5, 1999, the Company announced that its Board of Directors had approved a share repurchase program authorizing the Company to buy up to 4.0 million shares of its Common Stock. During 1999, the Company purchased approximately 1.8 million shares at a cost of approximately \$12.9 million. During 2000, the Company purchased approximately 0.2 million shares at a cost of approximately \$1.2 million. Under the current terms of the Credit Facility, the Company is prohibited from purchasing additional shares of its Common Stock.

Restricted Common Stock

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

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

COMFORT SYSTEMS USA, INC.

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

INTRODUCTION

The following discussion should be read in conjunction with the historical Consolidated Financial Statements of Comfort Systems USA, Inc. ("Comfort Systems" and collectively with its subsidiaries, the "Company") and related notes thereto included elsewhere in this Form 10-Q and the Annual Report on Form 10-K as filed with the Securities and Exchange Commission for the year ended December 31, 2000 (the "Form 10-K"). This discussion contains forward-looking statements regarding the business and industry of Comfort Systems within the meaning of the Private Securities Litigation Reform Act of 1995. These statements are based on the current plans and expectations of the Company and involve risks and uncertainties that could cause actual future activities and results of operations to be materially different from those set forth in the forward-looking statements. Important factors that could cause actual results to differ include risks set forth in "Factors Which May Affect Future Results," included in the Form 10-K.

The Company is a leading national provider of comprehensive heating, ventilation and air conditioning ("HVAC") installation, maintenance, repair and replacement services. The Company operates primarily in the commercial and industrial HVAC markets, and performs most of its services within manufacturing plants, office buildings, retail centers, apartment complexes, and healthcare, education and government facilities. In addition to standard HVAC services, the Company provides specialized applications such as process cooling, building automation control systems, electronic monitoring and process piping. Certain locations also perform related services such as electrical and plumbing.

RESULTS OF OPERATIONS

	THREE MONTHS ENDED JUNE 30,		SIX MONTHS ENDED JUNE 30,			
	2000	2001	2000	2001		
Revenues.....	\$404,970	100.0%	\$392,141	100.0%	\$767,536	
Cost of services.....	334,332	82.6%	323,070	82.4%	626,031	81.6%
Gross profit.....	70,638	17.4%	69,071	17.6%	141,505	18.4%
Selling, general and administrative expenses.....	56,333	13.9%	53,001	13.5%	111,161	14.5%
Goodwill amortization.....	3,149	0.8%	3,021	0.8%	6,042	0.8%
Restructuring charges.....	354	0.1%	354	0.1%	--	--
Operating income.....	10,802	2.7%	13,049	3.3%	23,658	3.1%
Other income (expense).....	(6,486)	(1.6)%	(6,222)	(1.6)%	(12,310)	(1.6)%
Reductions in non-operating assets and liabilities, net.....	(5,190)	(1.3)%	(5,190)	(0.7)%	--	--
Income (loss) before income taxes.....	(874)	(0.2)%	6,827	1.7%	6,158	0.8%
Income tax expense.....	31	0.0%	3,055	0.8%	4,539	0.6%
Net income (loss).....	\$ (905)	(0.2)%	\$ 3,291	0.8%	\$ 3,103	0.4%
					\$ 4,391	0.6%

Revenues -- Revenues decreased \$12.8 million, or 3.2%, to \$392.1 million for the second quarter of 2001 and decreased \$7.3 million, or 0.9%, to \$760.3 million for the first six months of 2001, compared to the same periods in 2000. The 3.2% decline in revenue for the quarter was comprised of a 1.1% decrease in revenues at ongoing operations, and a 2.1% decline in revenue related to operations that were sold or shut down since the second quarter of last year. The 0.9% decline in revenue for the first six months of 2001 was comprised of approximately 1.7% internal growth which was offset by a 2.6% decline in revenue related to operations that were sold or shut down since the second quarter of last year.

The Company's internal revenue growth rates are lower than the growth rates it experienced throughout 2000. This results in part from a general slowing in economic growth in the U.S. economy. The Company's revenue growth rates are also consistent with management's decreased emphasis on revenue growth in favor of improvement in profit margins, operating efficiency, and cash flow. In view of these factors, it is likely that the Company will continue to experience modest revenue growth in upcoming periods. There can be no assurance,

however, that this strategy will continue to lead to improved profit margins in the near term. In addition, if general economic activity in the U.S. slows significantly from current levels, the Company may realize further decreases in revenue growth and operating margins.

Gross Profit -- Gross profit decreased \$1.6 million, or 2.2%, to \$69.1 million for the second quarter of 2001 and decreased \$8.5 million, or 6.0%, to \$133.0 million for the first six months of 2001, compared to the same periods in 2000. As a percentage of revenues, gross profit increased from 17.4% for the three months ended June 30, 2000 to 17.6% for the three months ended June 30, 2001 and decreased from 18.4% for the first six months of 2000 to 17.5% for the first six months of 2001.

The Company's improvement in quarter-over-quarter gross profit percentage primarily resulted from divestiture, prior to the current quarter, of certain operations that performed poorly in last year's second quarter. The positive effect of this divestiture was offset to a lesser degree by additional reserves in connection with execution shortfalls and the lack of technical and skilled labor availability on certain sizable projects in the Central U.S. and California which are nearing completion. The Company also experienced subpar gross profit performance from certain operations that are undergoing operational and management changes. Management believes that gross profit performance and operating results will generally improve across these operations over the balance of the year.

Selling, General and Administrative Expenses ("SG&A") -- SG&A decreased \$3.3 million, or 5.9%, to \$53.0 million for the second quarter of 2001 and decreased \$5.7 million, or 5.1%, to \$105.5 million for the first six months of 2001, compared to the same periods in 2000. As a percentage of revenues, SG&A decreased from 13.9% for the three months ended June 30, 2000 to 13.5% for the three months ended June 30, 2001 and decreased from 14.5% for the first six months of 2000 to 13.9% for the first six months of 2001. The decrease in SG&A is primarily related to operations that were sold or shut down.

Restructuring Charges -- During the first quarter of 2001, the Company recorded restructuring charges of approximately \$0.2 million, primarily related to contractual severance obligations of two operating presidents in connection with the Company's significant restructuring program undertaken in the second half of 2000. These restructuring charges are net of a gain of approximately \$0.1 million related to management's decision to sell a small operation during the first quarter of 2001. During the second quarter of 2000, the Company recorded restructuring charges of approximately \$0.4 million, primarily in connection with severance costs related to the departure of the Company's former chief executive officer.

Reductions in Non-Operating Assets and Liabilities, Net -- During the quarter ended June 30, 2000, the Company recorded a non-cash charge of approximately \$5.2 million primarily related to the impairment of certain non-operating assets, principally notes receivable from former owners of businesses acquired by the Company. In addition, the Company recorded an impairment of approximately \$0.8 million to its minority investment in two entities associated with the distribution and implementation of high-end engineering and design software. The Company also recorded a gain of approximately \$0.6 million on the reduction of its subordinated note payable to a former owner in connection with the settlement of claims with this former owner.

Income Tax Expense -- The Company's effective tax rates for the six months ended June 30, 2001 and 2000 were 50.8% and 49.6%, respectively. The Company's provision for income taxes differs from the federal statutory rate primarily due to state income taxes (net of federal income tax benefit) and the non-deductibility of the amortization of goodwill attributable to certain acquisitions.

NEW ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 141 also specifies criteria for recording intangible assets other than goodwill in connection with business combinations. SFAS No. 142 requires companies to assess goodwill assets for impairment each year, and more frequently if circumstances suggest an

impairment may have occurred. SFAS No. 142 also introduces a more stringent framework for assessing goodwill impairment than the approach required under existing rules. In addition, SFAS No. 142 discontinues the regular charge, or amortization, of goodwill assets against income.

SFAS No. 141 is effective immediately. SFAS No. 142 is effective for the Company beginning January 1, 2002 and early adoption is not allowed for calendar year companies. Any impairment loss recognized in accordance with SFAS No. 142 will be shown as the cumulative effect of a change in accounting principle in the Company's income statement. Under this treatment, the Company's income statement would show after-tax results of operations both with and without the cumulative effect of the change in accounting principle recognizing an impairment.

The Company is currently reviewing these new accounting standards. Under existing standards, the Company recognizes a non-cash charge of approximately \$3 million per quarter in its income statement to amortize its goodwill assets over 40-year lives. This amortization will be discontinued beginning on January 1, 2002 under the new standards. In connection with this change, the Company also expects it will report a lower effective tax rate, since the portion of goodwill amortization that is nondeductible for tax purposes has been the principal item resulting in the excess of the Company's effective tax rate in its income statement over statutory tax rates.

The new requirements for assessing whether these goodwill assets have been impaired involve market-based information that may change prior to the new rules' effective date of January 1, 2002, and as noted above, early adoption is not allowed for the Company. As a result, the Company cannot yet determine whether it will have to recognize a goodwill impairment when the new rules become effective. However, based on a preliminary review of the new standards, and based on currently available information, the Company believes it is likely that it will have to record a non-cash goodwill impairment charge, and that the amount of that charge will be significant in relation to the Company's unamortized goodwill balance, which is expected to be approximately \$438 million at December 31, 2001. If such a charge is necessary, the Company anticipates it would be recorded in the first quarter of 2002 when the new standards become effective. As noted above, if an impairment charge is recorded upon transition to the new standards, it will be reflected as the cumulative effect of a change in accounting principle.

The Company has specifically provided for the possibility of a non-cash goodwill impairment charge in its lending agreements with its banks, and accordingly expects no impact on its current bank credit facility if recognition of such an impairment charge becomes necessary.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flow -- Cash provided by operating activities less customary capital expenditures plus the proceeds from asset sales is generally called free cash flow and, if positive, represents funds available to invest in significant operating initiatives, to acquire other companies or to reduce a company's outstanding debt or equity. If free cash flow is negative, additional debt or equity is generally required to fund the outflow of cash.

For the six months ended June 30, 2001, the Company had free cash flow of \$29.2 million, an increase of \$20.6 million as compared to free cash flow of \$8.6 million in the first six months of 2000. This improvement primarily resulted from faster billing by the Company for its project work while modestly improving the average days to collect receivables once billed, as well as a decrease in net capital expenditures versus the prior year.

Cash used in financing activities for the six months ended June 30, 2001 was \$29.0 million and was primarily attributable to net payments of long-term debt of \$29.6 million. Net cash used in financing activities for the six months ended June 30, 2000 was \$3.3 million and was primarily attributable to net borrowings of long-term debt primarily used for working capital and capital expenditures.

Revolving Credit Facility -- The Company amended its revolving credit facility (the "Credit Facility" or the "Facility") provided by Bank One, Texas, N.A. ("Bank One") and other banks (the "Bank Group") in March 2001. As amended, the Credit Facility provides the Company with a revolving line of credit of up to the lesser of \$270 million or 80% of net accounts receivable. The Facility decreases to the lesser of \$250 million or

80% of net accounts receivable as of December 31, 2001, and to the lesser of \$240 million or 80% of net accounts receivable as of June 30, 2002. Borrowings under the Facility are secured by accounts receivable, inventory, fixed assets other than real estate, and the shares of capital stock of the Company's subsidiaries. The Credit Facility expires on January 1, 2003, at which time all amounts outstanding are due.

The Company has a choice of two interest rate options under the Facility. Under one option, the interest rate is determined based on the higher of the Federal Funds Rate plus 0.5% or Bank One's prime rate. An additional margin of 1% to 2% is then added to the higher of these two rates. Under the other interest rate option, borrowings bear interest based on designated short-term Eurodollar rates (which generally approximate London Interbank Offered Rates or "LIBOR") plus 2.5% to 3.5%. The additional margin for both options depends on the ratio of the Company's debt to earnings before interest, taxes, depreciation and amortization ("EBITDA"), as defined. Commitment fees of 0.375% to 0.5% per annum, also depending on the ratio of debt to EBITDA, are payable on the unused portion of the Facility.

The Credit Facility prohibits payment of dividends and the repurchase of shares by the Company, limits certain non-Bank Group debt, and restricts outlays of cash by the Company relating to certain investments, capital expenditures, vehicle leases, acquisitions and subordinate debt. The Credit Facility also provides for the maintenance of certain levels of shareholder equity and EBITDA, and for the maintenance of certain ratios of the Company's EBITDA to interest expense and debt to EBITDA.

Under the terms of the Credit Facility that were in effect as of June 30 and September 30, 2000, the Company was in violation of certain of the Facility's financial balance and ratio requirements. The Bank Group waived these violations. The Facility's current restrictions and financial balance and ratio requirements generally reflect tighter restrictions, greater specificity and smaller allowable variances on most financial balances and ratios than is typical for such agreements due to the Company's weaker results in 2000. The Facility's current requirements also call for higher levels of EBITDA and lower ratios of debt to EBITDA in the second half of this year than the Company has achieved in recent quarters. While management believes its restructuring efforts and operating strategies along with general market conditions in the commercial/industrial HVAC and building automation controls industry will enable the Company to meet the Facility's requirements, there can be no assurance that the Company will be successful in doing so. Management intends to seek more flexible terms under its borrowing relationships as its results and credit market conditions allow.

As of June 30, 2001, the Company had \$200.0 million in borrowings outstanding under the Credit Facility and had incurred interest expense at an average rate of approximately 9.1% per annum for the first six months of 2001. The Credit Facility's interest rate terms as summarized above are effective as of March 22, 2001 and currently result in an all-in floating interest rate under the Facility's LIBOR option of approximately 7.7%. As of June 30, 2001, the Company also had \$2.3 million in letters of credit outstanding under the Facility, and unused borrowing capacity under the Facility of \$63.5 million. As of August 10, 2001, \$205.0 million in borrowings and \$2.3 million in letters of credit were outstanding under the Facility, and \$58.5 million in unused capacity was available.

Notes to Affiliates and Former Owners -- Subordinated notes were issued to former owners of certain purchased companies as part of the consideration used to acquire their companies. These notes had an outstanding balance of \$44.1 million as of June 30, 2001. These notes bear interest, payable quarterly, at a weighted average interest rate of 9.73%. In addition, \$0.6 million of these notes are convertible by the holders into shares of the Company's common stock ("Common Stock") at a weighted average price of \$24.25 per share.

As a result of the Company's covenant violations in 2000 under the Credit Facility, the Bank Group required that originally scheduled principal payments to subordinate debt holders be suspended. This requirement took effect in October 2000. The holders of the Company's subordinate debt generally must wait one year from any payment defaults to pursue collection remedies against the Company. In March 2001, the Company entered into amended agreements with subordinate debt holders representing \$46.3 million in principal, including all the principal originally scheduled to be paid through 2001. These amended agreements allow for partial payments against certain originally scheduled payment amounts, defer remaining principal balances to April 2003, and increase the interest rate on this debt to 10% per annum, payable quarterly. Under these amended agreements, \$6.4 million of principal has been paid from April 1, 2001 to August 10, 2001. The amended agreements also cured all defaults that arose from the suspension of principal payments to subordinate debt holders that began in October 2000. As a result of these amended agreements, the Company's annual maturities of subordinate debt are now \$3.1 million for the remainder of 2001, \$3.6 million in 2002, and \$37.4 million in 2003.

Outlook -- The Company anticipates that available borrowings under its Credit Facility and cash flow from operations will be sufficient to meet the Company's normal working capital and capital expenditure needs. As noted above, the Company has agreed to relatively tight restrictions under the Credit Facility. If the Company violates any of these restrictions, it will be required to negotiate new terms with its banks. There can be no assurance that in that event, the Company will receive satisfactory new terms from its banks, or that if the Company needs additional financing, that such financing can be secured when needed or on terms the Company deems acceptable.

Treasury Stock -- On October 5, 1999, the Company announced that its Board of Directors had approved a share repurchase program authorizing the Company to buy up to 4.0 million shares of its Common Stock. During 1999, the Company purchased approximately 1.8 million shares at a cost of approximately \$12.9 million. During 2000, the Company purchased approximately 0.2 million shares at a cost of approximately \$1.2 million. Under the current terms of the Credit Facility, the Company is prohibited from purchasing additional shares of its Common Stock.

SEASONALITY AND CYCLICALITY

The HVAC industry is subject to seasonal variations. Specifically, the demand for new installation and replacement is generally lower during the winter months due to reduced construction activity during inclement weather and less use of air conditioning during the colder months. Demand for HVAC services is generally higher in the second and third calendar quarters due to increased construction activity and increased use of air conditioning during the warmer months. Accordingly, the Company expects its revenues and operating results generally will be lower in the first and fourth calendar quarters.

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The Company is exposed to market risk primarily related to potential adverse changes in interest rates. Management is actively involved in monitoring exposure to market risk and continues to develop and utilize appropriate risk management techniques.

COMFORT SYSTEMS USA, INC.

PART II -- OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is subject to certain claims and lawsuits arising in the normal course of business and maintains various insurance coverages to minimize financial risk associated with these claims. The Company has provided accruals for probable losses and related legal fees associated with certain of these actions in its consolidated financial statements. In the opinion of management, uninsured losses, if any, resulting from the ultimate resolution of these matters will not have a material adverse effect on the Company's financial position or results of operations.

ITEM 2. RECENT SALES OF UNREGISTERED SECURITIES

During the three month period ended June 30, 2001, the Company did not issue any unregistered shares of its common stock.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

None.

(b) Reports on Form 8-K

None.

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

None.

SIGNATURE

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

COMFORT SYSTEMS USA, INC.

By: /s/ J. GORDON BEITTENMILLER

J. Gordon Beittenmiller
Executive Vice President,
Chief Financial Officer and
Director

Dated: August 13, 2001