

DELL INC
Form PRER14A
May 20, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A

Proxy Statement Pursuant to Section 14(a) of the
Securities Exchange Act of 1934

Filed by the Registrant

Filed by a Party other than the Registrant

Check the appropriate box:

Preliminary Proxy Statement

Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))

Definitive Proxy Statement

Definitive Additional Materials

Soliciting Material under Rule 14a-12

Dell Inc.

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(Name of Registrant as Specified In Its Charter)

(Name(s) of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

No fee required.

Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

Dell Inc. common stock, par value \$0.01 per share

(2) Aggregate number of securities to which transaction applies:

1,781,176,938 shares of common stock (including shares subject to restricted stock units and shares of restricted stock) and 25,482,624 shares of common stock underlying outstanding employee stock options with an exercise price of less than \$13.65 per share

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

In accordance with Exchange Act Rule 0-11(c), the filing fee of \$2,829,910.77 was determined by multiplying 0.0001364 by the aggregate merger consideration of \$20,747,146,376.79. The aggregate merger consideration was calculated as the sum of (i) the product of (a) 1,781,176,938 outstanding shares of common stock (including shares subject to restricted stock units and shares of restricted stock) as of March 25, 2013 to be acquired in the merger, multiplied by (b) the per share merger consideration of \$13.65, plus (ii) the product of (x) 25,482,624 shares of common stock underlying outstanding employee stock options with an exercise price of \$13.65 or less, multiplied by (y) \$6.46, representing the difference between the \$13.65 per share merger consideration and the \$7.19 weighted average exercise price of such options.

(4) Proposed maximum aggregate value of transaction:

\$20,747,146,376.79

(5) Total fee paid:

\$2,829,910.77

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Fee paid previously with preliminary materials.

Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

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**PRELIMINARY COPY SUBJECT TO
COMPLETION**

NOTICE OF SPECIAL MEETING

OF

STOCKHOLDERS

One Dell Way

Round Rock, Texas 78682

Telephone: (512) 728-7800

[], 2013

To the Stockholders of Dell Inc.:

You are cordially invited to attend a special meeting of the stockholders of Dell Inc., a Delaware corporation ("Dell, the Company, we, our or us"), which we will hold at the Dell Round Rock Campus, 501 Dell Way, Round Rock, Texas 78682 on [], 2013, at [], Central Time.

At the special meeting, holders of our common stock, par value \$0.01 per share ("Common Stock"), will be asked to consider and vote on a proposal to adopt the Agreement and Plan of Merger, dated as of February 5, 2013 (as it may be amended from time to time, the "merger agreement"), by and among Denali Holding Inc., a Delaware corporation ("Parent"), Denali Intermediate Inc., a Delaware corporation and a wholly-owned subsidiary of Parent ("Intermediate"), Denali Acquiror Inc., a Delaware corporation and a wholly-owned subsidiary of Intermediate ("Merger Sub") and, taken together with Intermediate and Parent, the "Parent Parties"), and the Company. Pursuant to the merger agreement, Merger Sub will be merged with and into the Company (the "merger"), with the Company surviving the merger as a wholly-owned subsidiary of Intermediate and each share of Common Stock outstanding immediately prior to the effective time of the merger (other than certain excluded shares and dissenting shares) will be canceled and converted into the right to receive \$13.65 in cash, without interest (the "merger consideration"), less any applicable withholding taxes. The following shares of Common Stock will not be entitled to the merger consideration: (i) shares held by any of the Parent Parties (including the shares held by Michael S. Dell and certain of his related family trusts which shares will be contributed to Parent prior to the merger), (ii) shares held by the Company or any wholly-owned subsidiary of the Company and (iii) shares held by any of the Company's stockholders who are entitled to and properly exercise appraisal rights under Delaware law.

The board of directors of the Company (the "Board") formed a committee (the "Special Committee") consisting solely of four independent and disinterested directors of the Company to evaluate the merger and other alternatives available to the Company. The Special Committee unanimously determined that the transactions contemplated by the merger agreement, including the merger, are fair to, and in the best interests of, the Company's stockholders (other than Mr. Dell and certain of his related family trusts), and unanimously recommended that the Board approve and declare advisable the merger agreement, a copy of which is attached as Annex A to the accompanying proxy statement, and the transactions contemplated therein, including the merger, and that the Company's stockholders vote for the adoption of the merger agreement. Based in part on that recommendation, the Board unanimously (other than Mr. Dell, who did not participate due to his interest in the merger) (i) determined that the transactions contemplated by the merger agreement, including the merger, are fair to, and in the best interests of, the Company's stockholders (other than Mr. Dell and certain of his related family trusts), (ii) approved and declared advisable the execution, delivery and performance of the merger agreement and the consummation of the transactions contemplated therein, including the merger and (iii) resolved to recommend that the Company's stockholders vote for the adoption of the merger agreement. **Accordingly, the Board (without Mr. Dell's participation) unanimously recommends that the stockholders of the Company**

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vote FOR the proposal to adopt the merger agreement. The Board also unanimously (without Mr. Dell's participation) recommends that the stockholders of the Company vote **FOR** the proposal to approve, on an advisory (non-binding) basis, the compensation that may become payable to the named executive officers of the Company in connection with the merger, as disclosed in the table under *Special Factors Interests of the Company's Directors and Executive Officers in the Merger Quantification of Payments and Benefits Potential Change of Control Payments to Named Executive Officers Table*, including the associated footnotes and narrative discussion.

In considering the recommendation of the Board, you should be aware that some of the Company's directors and executive officers have interests in the merger that are different from, or in addition to, the interests of the stockholders generally. As of May 16, 2013, Mr. Dell and certain of his related family trusts beneficially owned, in the aggregate, 274,434,319 shares of Common Stock (including (i) 1,101,948 shares subject to Company stock options exercisable within 60 days and (ii) 33,186 shares held in Mr. Dell's 401(k) plan), or approximately 15.6% of the total number of outstanding shares of Common Stock, and have agreed with Parent to contribute to Parent, immediately prior to the consummation of the merger, 273,299,383 shares in exchange for common stock of Parent.

We urge you to, and you should, read the accompanying proxy statement in its entirety, including the appendices, because it describes the merger agreement, the merger and related agreements and provides specific information concerning the special meeting and other important information related to the merger. In addition, you may obtain information about us from documents filed with the Securities and Exchange Commission.

Regardless of the number of shares of Common Stock you own, your vote is very important. The merger cannot be completed unless the merger agreement is adopted by the affirmative vote of the holders of (i) at least a majority of the outstanding shares of Common Stock entitled to vote thereon and (ii) at least a majority of the outstanding shares of Common Stock entitled to vote thereon held by stockholders other than the Parent Parties, Mr. Dell and certain of his related family trusts, any other officers and directors of the Company or any other person having any equity interest in, or any right to acquire any equity interest in, Merger Sub or any person of which Merger Sub is a direct or indirect subsidiary. If you fail to vote or abstain from voting on the merger agreement, the effect will be the same as a vote against adoption of the merger agreement.

While stockholders may exercise their right to vote their shares in person, we recognize that many stockholders may not be able to, or do not desire to, attend the special meeting. Accordingly, we have enclosed a proxy that will enable your shares to be voted on the matters to be considered at the special meeting even if you are unable or do not desire to attend. If you desire your shares to be voted in accordance with the Board's recommendation, you need only sign, date and return the proxy in the enclosed postage-paid envelope. Otherwise, please mark the proxy to indicate your voting instructions; date and sign the proxy; and return it in the enclosed postage-paid envelope. You also may submit a proxy by using a toll-free telephone number or the Internet. We have provided instructions on the proxy card for using these convenient services.

Submitting a proxy will not prevent you from voting your shares in person if you subsequently choose to attend the special meeting. Even if you plan to attend the special meeting in person, we request that you complete, sign, date and return the enclosed proxy and thus ensure that your shares will be represented at the special meeting if you are unable to attend.

Sincerely,

Alex J. Mandl

Chairman of the Special Committee

Neither the Securities and Exchange Commission nor any state securities regulatory agency has approved or disapproved the merger, passed upon the merits or fairness of the merger or passed upon the adequacy or accuracy of the disclosure in this document. Any representation to the contrary is a criminal offense.

This proxy statement is dated [], 2013

and is first being mailed to stockholders on or about [], 2013.

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PRELIMINARY COPY SUBJECT TO COMPLETION

DELL INC.

One Dell Way

Round Rock, Texas 78682

Telephone: (512) 728-7800

NOTICE OF SPECIAL MEETING OF STOCKHOLDERS

To the Stockholders of Dell Inc.:

NOTICE IS HEREBY GIVEN that a special meeting of the stockholders of Dell Inc., a Delaware corporation (Dell, the Company, we, our or us), will be held at the Dell Round Rock Campus, 501 Dell Way, Round Rock, Texas 78682 on [], 2013, at [], Central Time, for the following purposes:

1. to consider and vote on a proposal to adopt the Agreement and Plan of Merger, dated as of February 5, 2013, as it may be amended from time to time, (the merger agreement), by and among Denali Holding Inc., a Delaware corporation (Parent), Denali Intermediate Inc., a Delaware corporation and a wholly-owned subsidiary of Parent (Intermediate), Denali Acquiror Inc., a Delaware corporation and a wholly-owned subsidiary of Intermediate (Merger Sub and, taken together with Intermediate and Parent, the Parent Parties), and the Company;
2. to approve, on an advisory (non-binding) basis, the compensation that may become payable to the named executive officers of the Company in connection with the merger, as disclosed in the table under *Special Factors Interests of the Company s Directors and Executive Officers in the Merger Quantification of Payments and Benefits Potential Change of Control Payments to Named Executive Officers Table*, including the associated footnotes and narrative discussion;
3. to approve the adjournment of the special meeting, if necessary or appropriate, to solicit additional proxies if there are insufficient votes at the time of the special meeting to approve the proposal to adopt the merger agreement; and
4. to act upon other business as may properly come before the special meeting or any adjournment or postponement thereof by or at the direction of the Board.

The holders of record of our common stock, par value \$0.01 per share (Common Stock), at the close of business on [], 2013, are entitled to notice of and to vote at the special meeting or at any adjournment or postponement thereof. All stockholders of record are cordially invited to attend the special meeting in person.

Your vote is important, regardless of the number of shares of Common Stock you own. The adoption of the merger agreement by the affirmative vote of the holders of (i) at least a majority of the outstanding shares of Common Stock entitled to vote thereon and (ii) at least a majority of the outstanding shares of Common Stock entitled to vote thereon held by stockholders other than the Parent Parties, Michael S. Dell and certain of his related family trusts, any other officers and directors of the Company and any other person having any equity interest in, or any right to acquire any equity interest in, Merger Sub or any person of which Merger Sub is a direct or indirect subsidiary are conditions to the consummation of the merger. The proposal to approve, on an advisory (non-binding) basis, the compensation that may become payable to the named executive officers of the Company in connection with the merger, as disclosed in the table under *Special Factors Interests of the Company s Directors and Executive Officers in the Merger Quantification of Payments and Benefits Potential Change of Control Payments to Named Executive Officers Table*, including the associated footnotes and narrative discussion, and the proposal to approve the adjournment of the special meeting to solicit additional proxies, if necessary or appropriate, each require the affirmative vote of holders of a majority of the voting

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power present and entitled to vote thereon. Even if you plan to attend the special meeting in person, we request that you complete, sign, date and return the enclosed proxy and thus ensure that your shares will be represented at the special meeting if you are unable to attend.

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You also may submit your proxy by using a toll-free telephone number or the Internet. We have provided instructions on the proxy card for using these convenient services.

If you sign, date and return your proxy card without indicating how you wish to vote, your proxy will be voted in favor of the proposal to adopt the merger agreement, the proposal to approve, on an advisory (non-binding) basis, the compensation that may become payable to the named executive officers of the Company in connection with the merger, as disclosed in the table under *Special Factors Interests of the Company's Directors and Executive Officers in the Merger Quantification of Payments and Benefits Potential Change of Control Payments to Named Executive Officers Table*, including the associated footnotes and narrative discussion, and the proposal to approve the adjournment of the special meeting to solicit additional proxies, if necessary or appropriate. If you fail to vote or submit your proxy, the effect will be that your shares will not be counted for purposes of determining whether a quorum is present at the special meeting and will have the same effect as a vote against the proposal to adopt the merger agreement. However, failure to vote or submit your proxy will not affect the vote regarding the proposal to approve, on an advisory (non-binding) basis, the compensation that may become payable to the named executive officers of the Company in connection with the merger, as disclosed in the table under *Special Factors Interests of the Company's Directors and Executive Officers in the Merger Quantification of Payments and Benefits Potential Change of Control Payments to Named Executive Officers Table*, including the associated footnotes and narrative discussion, or the vote regarding the proposal to approve the adjournment of the special meeting to solicit additional proxies, if necessary or appropriate.

Your proxy may be revoked at any time before the vote at the special meeting by following the procedures outlined in the accompanying proxy statement. If you are a stockholder of record, attend the special meeting and wish to vote in person, you may revoke your proxy and vote in person.

BY ORDER OF THE BOARD OF DIRECTORS

Lawrence P. Tu

General Counsel and Secretary

Dated [], 2013

Round Rock, Texas

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SUMMARY TERM SHEET

This Summary Term Sheet discusses the material information contained in this proxy statement, including with respect to the merger agreement, as defined below, the merger and the other agreements entered into in connection with the merger. We encourage you to read carefully this entire proxy statement, including its annexes and the documents referred to or incorporated by reference in this proxy statement, as this Summary Term Sheet may not contain all of the information that may be important to you. The items in this Summary Term Sheet include page references directing you to a more complete description of that topic in this proxy statement.

The Parties to the Merger (page 131)

Dell Inc.

Dell Inc. (Dell, the Company, we, our or us) is a Delaware corporation. Founded by Michael S. Dell in 1984, the Company is a leading global integrated solutions provider in the IT industry. The Company is focused on providing complete technology solutions to our customers that are scalable, flexible and easy to use. Over time, the Company has added new distribution channels, such as retail, system integrators, value-added resellers and distributors, to expand its access to more end-users around the world. See *Important Information Regarding Dell Company Background* beginning on page 165. See also *The Parties to the Merger Dell Inc.* on page 131.

Additional information about Dell is contained in its public filings, which are incorporated by reference herein. See *Where You Can Find Additional Information* on page 190.

The Parent Parties

Denali Holding Inc. (Parent) is a newly formed Delaware corporation. Denali Intermediate Inc. (Intermediate) is a newly formed Delaware corporation and a wholly-owned subsidiary of Parent. Denali Acquiror Inc. (Merger Sub and, together with Intermediate and Parent, the Parent Parties) is a newly formed Delaware corporation and a wholly-owned subsidiary of Intermediate. Each of the Parent Parties is an affiliate of the entities referred to as the SLP Filing Persons (see *Important Information Regarding the Parent Parties, the SLP Filing Persons, the MD Filing Persons and the MSDC Filing Persons The SLP Filing Persons* beginning on page 187) and the persons and entities referred to as the MD Filing Persons (see *Important Information Regarding the Parent Parties, the SLP Filing Persons, the MD Filing Persons and the MSDC Filing Persons The MD Filing Persons* beginning on page 188) and was formed solely for the purpose of entering into the merger agreement and consummating the transactions contemplated by the merger agreement. None of the Parent Parties has engaged in any business except for activities incident to its formation and in connection with the transactions contemplated by the merger agreement. See *Important Information Regarding the Parent Parties, the SLP Filing Persons, the MD Filing Persons and the MSDC Filing Persons* beginning on page 186. See also *The Parties to the Merger The Parent Parties* on page 131.

The Purpose of the Special Meeting (page 132)

You will be asked to consider and vote upon the proposal to adopt the Agreement and Plan of Merger, dated as of February 5, 2013 (as it may be amended from time to time, the merger agreement), by and among Parent, Intermediate, Merger Sub and the Company. The merger agreement provides that at the effective time of the merger, Merger Sub will be merged with and into the Company (the merger), with the Company surviving the merger as a wholly-owned subsidiary of Intermediate. At the effective time of the merger, each share of common stock, par value \$0.01 per share, of the Company (the Common Stock) outstanding immediately prior to the effective time of the merger (other than certain excluded shares and shares held by any of the Company s stockholders who are entitled to and properly exercise appraisal rights under Delaware law (dissenting shares))

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will be converted into the right to receive \$13.65 in cash, without interest (the merger consideration), less any applicable withholding taxes, whereupon all such shares will be automatically canceled upon the conversion thereof and will cease to exist, and the holders of such shares will cease to have any rights with respect thereto other than the right to receive the merger consideration. Shares of Common Stock held by any of the Parent Parties (including the shares held by the MD Investors and the Gift Trusts (each as defined below), which shares will be contributed to Parent prior to the merger) and by the Company or any wholly-owned subsidiary of the Company will not be entitled to receive the merger consideration.

Following and as a result of the merger, the Company will become a privately held company, wholly-owned directly by Intermediate and indirectly by Parent, which in turn will be owned by the following entities and individuals:

Silver Lake Partners III, L.P., Silver Lake Partners IV, L.P. (together with Silver Lake Partners III, L.P., the SLP Investors) and their permitted assignees, if any, which have agreed, severally but not jointly, to provide an aggregate amount of up to \$1.4 billion in cash equity financing for the merger;

Michael S. Dell, Chairman and Chief Executive Officer of the Company, and The Susan Lieberman Dell Separate Property Trust (together with Mr. Dell, the MD Investors), who together have agreed, severally and not jointly, to transfer, contribute and deliver to Parent, immediately prior to the consummation of the merger, 273,299,383 shares of the Common Stock (including shares held by the Michael S. Dell 2009 Gift Trust and Susan L. Dell 2009 Gift Trust (together, the Gift Trusts), which shares will be acquired by Mr. Dell from the Gift Trusts prior to the consummation of the merger (conditional upon the occurrence of the closing of the merger)) in exchange for common stock of Parent, and, in the case of Mr. Dell, to provide up to an additional \$500 million in cash equity financing for the merger; and

MSDC Management, L.P. (the MSDC Investor) and its permitted assignees, if any, which have agreed to provide an aggregate amount of up to \$250 million in cash equity financing for the merger.

The Special Meeting (Page 132)

The special meeting will be held at the Dell Round Rock Campus, 501 Dell Way, Round Rock, Texas 78682 on [], 2013, at [], Central Time.

Record Date and Quorum (Page 133)

The holders of record of the Common Stock as of the close of business on [], 2013, the record date for determination of stockholders entitled to notice of and to vote at the special meeting, are entitled to receive notice of and to vote at the special meeting.

The presence at the special meeting, in person or by proxy, of the holders of a majority of the voting power of the shares of Common Stock outstanding and entitled to vote on the record date will constitute a quorum, permitting the Company to conduct its business at the special meeting.

Required Vote (Page 133)

For the Company to consummate the merger, under Delaware law and under the merger agreement, stockholders holding at least a majority of the shares of Common Stock outstanding and entitled to vote at the close of business on the record date must vote **FOR** the proposal to adopt the merger agreement. In addition, it is a condition to the consummation of the merger that stockholders holding at least a majority of the shares of Common Stock outstanding and entitled to vote at the close of business on the record date, other than the Parent Parties, the MD Investors, the Gift Trusts, any other officers and directors of the Company and any other person having any equity interest in, or any right to acquire any equity interest in, Merger Sub or any person of which Merger Sub is a direct or indirect subsidiary, vote **FOR** the proposal to adopt the merger agreement.

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Subject to certain conditions, the MD Investors and the Gift Trusts have agreed to vote, or cause to be voted, all of the outstanding shares of Common Stock they beneficially own in favor of the proposal to adopt the merger agreement pursuant to a voting and support agreement that they entered into with the Company on February 5, 2013 (the voting agreement). See *Special Factors Interests of the Company's Directors and Executive Officers in the Merger Voting Agreement* on page 123.

Conditions to the Merger (Page 159)

Each party's obligation to complete the merger is subject to the satisfaction of the following conditions:

the proposal to adopt the merger agreement has been approved by the affirmative vote of holders of at least a majority of the outstanding shares of the Common Stock entitled to vote thereon;

the proposal to adopt the merger agreement has been approved by the affirmative vote of holders of at least a majority of the outstanding shares of the Common Stock entitled to vote thereon, other than the Parent Parties, the MD Investors, the Gift Trusts and any other officers and directors of the Company and any other person having any equity interest in, or any right to acquire any equity interest in, Merger Sub or any person of which Merger Sub is a direct or indirect subsidiary;

there is no injunction or similar order prohibiting the consummation of the merger (i) by a governmental entity having jurisdiction over the business of the Company and its subsidiaries (other than a *de minimis* portion of such business) or (ii) that, if not abided by, would potentially result in criminal liability;

there is no law prohibiting or making illegal the merger (i) by any governmental entity in a jurisdiction in which the business of the Company and its subsidiaries is conducted (other than a *de minimis* portion of such business) or (ii) that, if not abided by, would potentially result in criminal liability; and

any applicable waiting period (and any extensions thereof) has expired or been terminated and any required approvals, consents or clearances have been obtained relating to the merger under (i) the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (the HSR Act), (ii) if required or if jurisdiction is accepted, Council Regulation (EC) No 139/2004 of the European Union Merger Regulation, or, if not required or jurisdiction is not accepted, the antitrust and competition laws of the Member States of the European Union and European Economic Area in which a filing is required and (iii) the antitrust and competition laws of China and certain other jurisdictions.

The obligation of the Company to complete the merger is also subject to the satisfaction or waiver of the following additional conditions:

the representations and warranties of the Parent Parties in the merger agreement must be true and correct in all material respects both when made and as of the closing date of the merger (except with respect to certain representations and warranties made as of a specified date), except where the failure to be true and correct would not impair, prevent or delay in any material respect the ability of any of the Parent Parties to perform its obligations under the merger agreement;

the Parent Parties must have performed in all material respects all obligations that they are required to perform under the merger agreement prior to the closing; and

each of the Parent Parties must have delivered to the Company an officer's certificate stating that the conditions set forth above have been satisfied.

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The respective obligations of the Parent Parties to complete the merger are also subject to the satisfaction or waiver of the following additional conditions:

the representations and warranties of the Company in the merger agreement relating to (i) capitalization, (ii) dividends, (iii) the absence of any material adverse effect since November 2,

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2012, (iv) finder's and broker's fees and (v) takeover laws and rights agreements must be true and correct (except, subject to certain exceptions, for such inaccuracies as are *de minimis*) both when made and as of the closing date of the merger or, with respect to certain representations and warranties, as of a specified date;

the representations and warranties of the Company in the merger agreement relating to (i) the Company's subsidiaries, (ii) corporate authority and (iii) outstanding indebtedness must be true and correct in all material respects both when made and as of the closing date of the merger or, with respect to certain representations and warranties, as of a specified date;

the other representations and warranties of the Company in the merger agreement (except those listed in the above preceding bullet points) must be true and correct both when made and as of the closing date of the merger or, with respect to certain representations and warranties, as of a specified date, except where the failure to be true and correct would not result in a material adverse effect, as described under *The Merger Agreement - Conditions to the Merger* beginning on page 159;

the Company must have performed in all material respects all obligations that it is required to perform under the merger agreement prior to the closing date of the merger;

the Company must have delivered to Parent an officer's certificate stating that the conditions set forth above have been satisfied; and

Parent must not have the right to terminate the merger agreement as a result of the Company's cash on hand being less than \$7.4 billion as of the beginning of the day on which the closing of the merger would have been required to occur but for the failure of this condition.

When the Merger Becomes Effective (Page 139)

We currently anticipate holding our stockholders' meeting to vote on the merger agreement during the second quarter of our current fiscal year, which quarter will end on August 2, 2013, and completing the merger during the third quarter of our current fiscal year, which quarter will end on November 1, 2013, subject to approval of the proposal to adopt the merger agreement by the Company's stockholders as specified herein and the satisfaction of the other closing conditions.

Reasons for the Merger; Recommendation of the Board of Directors; Fairness of the Merger (Page 50)

The Board, acting upon the unanimous recommendation of a committee of the Board consisting solely of four independent and disinterested directors of the Company (the *Special Committee*), unanimously (without Mr. Dell's participation) has recommended that the stockholders of the Company vote **FOR** the proposal to adopt the merger agreement. For a description of the reasons considered by the Special Committee and the Board in deciding to recommend approval of the proposal to adopt the merger agreement, see *Special Factors - Reasons for the Merger; Recommendation of the Board of Directors; Fairness of the Merger* beginning on page 50.

Opinion of J.P. Morgan Securities LLC (Page 62 and Annex B)

The Special Committee retained J.P. Morgan Securities LLC (J.P. Morgan) to act as its financial advisor in connection with the proposed merger. At separate meetings of the Special Committee and the Board on February 4, 2013, J.P. Morgan rendered its oral opinion, subsequently confirmed in writing, that as of February 4, 2013, and based upon and subject to the factors and assumptions set forth therein, the consideration to be paid to the holders of the Common Stock (other than shares of Common Stock held in treasury or owned by Merger Sub and its subsidiaries, other excluded shares, Company restricted shares and dissenting shares) in the proposed merger was fair, from a financial point of view, to such holders.

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The full text of the written opinion of J.P. Morgan, dated February 4, 2013, is attached to this proxy statement as Annex B and is incorporated into this proxy statement by reference. The opinion sets forth the assumptions made, procedures followed, matters considered and limits on the review undertaken by J.P. Morgan in rendering its opinion. You are urged to read the opinion carefully in its entirety. J.P. Morgan's written opinion was provided to the Special Committee and the Board, is directed only to the fairness from a financial point of view of the merger consideration to be paid in the proposed merger and it does not constitute a recommendation to any stockholder of the Company as to how such stockholder should vote with respect to the merger or any other matter. For a further discussion of J.P. Morgan's opinion, see *Special Factors Opinion of J.P. Morgan Securities LLC* beginning on page 62 and Annex B to this proxy statement.

Opinion of Evercore Group L.L.C. (Page 69 and Annex C)

The Special Committee retained Evercore Group L.L.C. (Evercore) to act as our financial advisor in connection with the proposed merger. At separate meetings of the Special Committee and the Board on February 4, 2013, Evercore rendered its oral opinion, subsequently confirmed in writing, that as of February 4, 2013, and based upon, and subject to, the factors, procedures, assumptions, qualifications and limitations and other matters set forth therein, the \$13.65 per share merger consideration was fair, from a financial point of view, to the holders of shares of Common Stock entitled to receive such merger consideration.

The full text of the written opinion of Evercore, dated February 4, 2013, is attached to this proxy statement as Annex C and is incorporated into this proxy statement by reference. The opinion sets forth, among other things, the factors considered, procedures followed, assumptions made and qualifications and limitations on the scope of review undertaken by Evercore in rendering its opinion. You are urged to read the opinion carefully in its entirety. Evercore's opinion was addressed to, and was provided for the information and benefit of, the Special Committee and the Board (in their capacity as such) in connection with their evaluation of whether the merger consideration to be received by the holders of the shares of Common Stock was fair, from a financial point of view, to the holders of the shares of Common Stock entitled to receive such merger consideration. The opinion does not address any other aspect of the merger and does not constitute a recommendation to the Special Committee, the Board or to any other person in respect of the merger, including as to how any of our stockholders should act or vote with respect to the merger. Evercore's opinion did not address the relative merits of the merger as compared to other business or financial strategies that might be available to the Company, nor did it address the underlying business decision of the Company to engage in the merger. In arriving at its opinion, Evercore was not authorized to solicit, and did not solicit, interest from any third party with respect to the acquisition of any or all of the Common Stock or any business combination or other extraordinary transaction involving the Company. For a further discussion of Evercore's opinion, see *Special Factors Opinion of Evercore Group L.L.C.* beginning on page 69 and Annex C to this proxy statement.

Purposes and Reasons of the Company for the Merger (Page 87)

The Company's purpose for engaging in the merger is to enable its stockholders to receive \$13.65 per share in cash, without interest and less any applicable withholding taxes, which \$13.65 per share merger consideration represents a premium of approximately

\$46,138 \$38,880 **\$107,804** \$93,960

Class B common stock

4,217 3,568 **9,867** 8,629

\$50,355 \$42,448 **\$117,671** \$102,589

Diluted Earnings per Share:

Net income attributable to Watsco, Inc. shareholders

\$54,461 \$45,699 **\$127,315** \$110,402

Less: distributed and undistributed earnings allocated to non-vested (restricted) common stock

4,103 3,246 **9,635** 7,801

Earnings allocated to Watsco, Inc. shareholders

| | | | |
|-----------------|----------|------------------|-----------|
| \$50,358 | \$42,453 | \$117,680 | \$102,601 |
|-----------------|----------|------------------|-----------|

Weighted-average common shares outstanding Basic

| | | | |
|-------------------|------------|-------------------|------------|
| 32,330,888 | 32,206,448 | 32,292,559 | 32,182,430 |
|-------------------|------------|-------------------|------------|

Effect of dilutive stock options

| | | | |
|---------------|--------|---------------|--------|
| 45,051 | 69,665 | 52,509 | 63,936 |
|---------------|--------|---------------|--------|

Weighted-average common shares outstanding Diluted

| | | | |
|-------------------|------------|-------------------|------------|
| 32,375,939 | 32,276,113 | 32,345,068 | 32,246,366 |
|-------------------|------------|-------------------|------------|

Diluted earnings per share for Common and Class B common stock

\$1.56 \$1.32 **\$3.64** \$3.18

Anti-dilutive stock options not included in above

28,565 620 **7,788** 4,963

Diluted earnings per share for our Common stock assumes the conversion of all of our Class B common stock into Common stock as of the beginning of the fiscal year; therefore, no allocation of earnings to Class B common stock is required. As of September 30, 2014 and 2013, our outstanding Class B common stock was convertible into 2,707,725 and 2,706,860 shares of our Common stock, respectively.

3. OTHER COMPREHENSIVE (LOSS) INCOME

Other comprehensive (loss) income consists of the foreign currency translation adjustment associated with our Canadian operations use of the Canadian dollar as their functional currency and changes in the unrealized (loss) gain on available-for-sale securities. The tax effects allocated to each component of other comprehensive (loss) income were as follows:

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| | Quarter Ended September 30, | | Nine Months Ended September 30, | |
|---|--------------------------------|----------|------------------------------------|------------|
| | 2014 | 2013 | 2014 | 2013 |
| Foreign currency translation adjustment | \$ (11,996) | \$ 5,073 | \$ (12,648) | \$ (8,367) |
| Unrealized (loss) gain on available-for-sale securities | \$ (9) | \$ 27 | \$ (21) | \$ 24 |
| Income tax benefit (expense) | 4 | (9) | 8 | (9) |
| Unrealized (loss) gain on available-for-sale securities, net of tax | \$ (5) | \$ 18 | \$ (13) | \$ 15 |
| Other comprehensive (loss) income | \$ (12,001) | \$ 5,091 | \$ (12,661) | \$ (8,352) |

The changes in accumulated other comprehensive loss, net of tax, are as follows:

| <i>Nine Months Ended September 30,</i> | 2014 | 2013 |
|--|-------------|------------|
| Foreign currency translation adjustment: | | |
| Beginning balance | \$ (11,181) | \$ (1,785) |
| Current period other comprehensive loss | (7,394) | (4,772) |
| Ending balance | \$ (18,575) | \$ (6,557) |
| Available-for-sale securities: | | |
| Beginning balance | \$ (293) | \$ (317) |
| Current period other comprehensive (loss) income | (13) | 15 |
| Ending balance | \$ (306) | \$ (302) |
| Accumulated other comprehensive loss, net of tax | \$ (18,881) | \$ (6,859) |

4. DERIVATIVE FINANCIAL INSTRUMENTS

We routinely use derivative instruments to hedge foreign currency exposure. Although these derivatives were not designated as hedges and/or did not qualify for hedge accounting, they were effective economic hedges for the periods presented. The changes in fair values of economic hedges are recognized in earnings. During 2014 and 2013, we entered into foreign currency forward contracts to offset the earnings impact that foreign currency exchange rate fluctuations would otherwise have had on certain monetary liabilities denominated in nonfunctional currencies. The changes in fair values of foreign currency forward contracts were gains (losses) of \$2,127 and \$(1,534) for the quarters ended September 30, 2014 and 2013, respectively. The changes in fair values of foreign currency forward contracts were gains (losses) of \$572 and \$(6) for the nine months ended September 30, 2014 and 2013, respectively. These amounts are included in selling, general and administrative expenses in our condensed consolidated unaudited statements of income. The total notional value of our foreign currency exchange contracts as of September 30, 2014 was \$19,500, and such contracts have varying terms expiring through November 2014. See Note 5.

Table of Contents**5. FAIR VALUE MEASUREMENTS**

The following tables present our assets and liabilities carried at fair value that are measured on a recurring basis:

| | Balance Sheet Location | Total | Fair Value Measurements at September 30, 2014 Using | | |
|----------------------------------|------------------------|--------|--|------------|------------|
| | | | Level 1 | Level 2 | Level 3 |
| Assets: | | | | | |
| Available-for-sale securities | Other assets | \$ 244 | \$ 244 | | |
| Derivative financial instruments | Other current assets | \$ 690 | | \$ 690 | |

| | Balance Sheet Location | Total | Fair Value Measurements at December 31, 2013 Using | | |
|----------------------------------|------------------------|--------|---|------------|------------|
| | | | Level 1 | Level 2 | Level 3 |
| Assets: | | | | | |
| Available-for-sale securities | Other assets | \$ 265 | \$ 265 | | |
| Derivative financial instruments | Other current assets | \$ 118 | | \$ 118 | |

The following is a description of the valuation techniques used for these assets and liabilities, as well as the level of input used to measure fair value:

Available-for-sale securities these investments are exchange-traded equity securities. Fair values for these investments are based on closing stock prices from active markets and are therefore classified within Level 1 of the fair value hierarchy.

Derivative financial instruments these derivatives are foreign currency forward contracts. See Note 4. Fair value is based on observable market inputs, such as forward rates in active markets; therefore, we classify these derivatives within Level 2 of the valuation hierarchy.

There were no transfers in or out of Level 1 and Level 2 during the nine months ended September 30, 2014.

6. PURCHASE OF OWNERSHIP INTEREST IN JOINT VENTURE

On July 1, 2014, we exercised our second option to acquire an additional 10% ownership interest in Carrier Enterprise, LLC (Carrier Enterprise I) for cash consideration of \$87,735, following which we have an 80% controlling interest in Carrier Enterprise I. Neither we nor Carrier has any remaining options to purchase additional ownership interests in Carrier Enterprise I, or any of our other joint ventures with Carrier.

7. DEBT

On June 25, 2014, we entered into an amendment to our unsecured, syndicated revolving credit agreement, which increased the borrowing capacity from \$500,000 to \$600,000, extended the maturity date from July 1, 2018 to July 1, 2019, increased the swingline subfacility from \$65,000 to \$90,000 and modified certain definitions. At September 30, 2014 and December 31, 2013, \$352,003 and \$230,044 was outstanding under the revolving credit agreement, respectively. The revolving credit agreement contains customary affirmative and negative covenants, including

financial covenants with respect to consolidated leverage and interest coverage ratios, and other customary restrictions. We believe we were in compliance with all such covenants at September 30, 2014.

8. SHAREHOLDERS EQUITY

Common Stock Dividends

We paid cash dividends of \$0.60, \$0.25, \$1.40 and \$0.75 per share of Common stock and Class B common stock during the quarters and nine months ended September 30, 2014 and 2013, respectively.

Non-Vested (Restricted) Stock

During the quarters ended September 30, 2014 and 2013, we granted 10,700 and 31,500 shares of non-vested (restricted) stock, respectively. During the nine months ended September 30, 2014 and 2013, we granted 213,725 and 119,043 shares of non-vested (restricted) stock, respectively.

During the nine months ended September 30, 2014, 21,028 shares of Common stock with an aggregate fair market value of \$2,125 were withheld as payment in lieu of cash to satisfy tax withholding obligations in connection with the vesting of non-vested (restricted) stock. These shares were retired upon delivery.

Table of Contents**Exercise of Stock Options**

During the quarters ended September 30, 2014 and 2013, 17,850 and 34,700 stock options, respectively, were exercised for common stock. During the nine months ended September 30, 2014 and 2013, 41,350 and 44,200 stock options, respectively, were exercised for common stock. Cash received from common stock issued as a result of stock options exercised during the quarters and nine months ended September 30, 2014 and 2013, was \$613, \$1,162, \$1,942 and \$1,539, respectively.

During both the quarter and nine months ended September 30, 2014, 5,454 shares of Class B Common stock with an aggregate fair market value of \$490 were withheld as payment in lieu of cash for stock option exercises and related tax withholdings. During both the quarter and nine months ended September 30, 2013, 5,448 shares of Class B Common stock with an aggregate fair market value of \$490 were delivered as payment in lieu of cash for stock option exercises and related tax withholdings. These shares were retired upon delivery.

Employee Stock Purchase Plan

During the quarters ended September 30, 2014 and 2013, 2,741 and 1,944 shares of Common stock were issued under our employee stock purchase plan for which we received net proceeds of \$259 and \$160, respectively. During the nine months ended September 30, 2014 and 2013, 6,984 and 5,870 shares of Common stock were issued under our employee stock purchase plan for which we received net proceeds of \$662 and \$459, respectively.

401(k) Plan

During the nine months ended September 30, 2014 and 2013, we issued 18,309 and 22,551 shares of Common stock, respectively, to our profit sharing retirement plan, representing the Common stock discretionary matching contribution of \$1,759 and \$1,689, respectively.

Noncontrolling Interest

Effective July 1, 2014, our controlling interest in Carrier Enterprise I increased to 80% from 70%, following our exercise of the option described in Note 6. We have a 60% controlling interest in our other two joint ventures with Carrier, while Carrier has a 40% noncontrolling interest in each. The following table reconciles shareholders' equity attributable to Carrier's noncontrolling interest:

| | |
|---|-------------------|
| Noncontrolling interest at December 31, 2013 | \$ 286,996 |
| Decrease in noncontrolling interest in Carrier Enterprise I | (44,411) |
| Distributions to noncontrolling interest | (25,817) |
| Foreign currency translation adjustment | (5,254) |
| Net income attributable to noncontrolling interest | 46,604 |
| Noncontrolling interest at September 30, 2014 | \$ 258,118 |

9. COMMITMENTS AND CONTINGENCIES**Litigation, Claims and Assessments**

We are involved in litigation incidental to the operation of our business. We vigorously defend all matters in which we or our subsidiaries are named defendants and, for insurable losses, maintain significant levels of insurance to protect against adverse judgments, claims or assessments that may affect us. Although the adequacy of existing insurance coverage and the outcome of any legal proceedings cannot be predicted with certainty, based on the current information available, we do not believe the ultimate liability associated with any known claims or litigation will have a material adverse effect on our financial condition or results of operations.

Self-Insurance

Self-insurance reserves are maintained relative to company-wide casualty insurance and health benefit programs. The level of exposure from catastrophic events is limited by the purchase of stop-loss and aggregate liability reinsurance coverage. When estimating the self-insurance liabilities and related reserves, management considers a number of factors, which include historical claims experience, demographic factors, severity factors and valuations provided by independent third-party actuaries. Management reviews its assumptions with its independent third-party actuaries to evaluate whether the self-insurance reserves are adequate. If actual claims or adverse development of loss reserves occur and exceed these estimates, additional reserves may be required. Reserves in the amounts of \$4,999 and \$5,582 at September 30, 2014 and December 31, 2013, respectively, were established related to such programs and are included in accrued expenses and other current liabilities in our condensed consolidated unaudited balance sheets.

10. RELATED PARTY TRANSACTIONS

Purchases from Carrier and its affiliates comprised 63% and 62% of all inventory purchases for the quarters ended September 30, 2014 and 2013, respectively. Purchases from Carrier and its affiliates comprised 61% and 58% of all inventory purchases for the nine months ended September 30, 2014 and 2013, respectively. At September 30, 2014 and December 31, 2013, approximately \$103,000 and \$53,000, respectively, was payable to Carrier and its affiliates, net of receivables. Our joint ventures with Carrier also sell HVAC products to Carrier and its affiliates. Revenues in our condensed consolidated unaudited statements of income for the quarters and nine months ended September 30, 2014 and 2013 included \$11,518, \$7,834, \$29,181 and \$21,822, respectively, of sales to Carrier and its affiliates. We believe these transactions are conducted at arm's-length in the ordinary course of business.

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

Forward-Looking Statements

This Quarterly Report contains or incorporates by reference statements that are not historical in nature and that are intended to be, and are hereby identified as, forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995, including statements regarding, among other items, (i) economic conditions, (ii) business and acquisition strategies, (iii) potential acquisitions and/or joint ventures, (iv) financing plans and (v) industry, demographic and other trends affecting our financial condition or results of operations. These forward-looking statements are based on management's current expectations and are subject to a number of risks, uncertainties and changes in circumstances, certain of which are beyond their control.

Actual results could differ materially from these forward-looking statements as a result of several factors, including, but not limited to:

General economic conditions;

Competitive factors within the HVAC/R industry;

Effects of supplier concentration;

Fluctuations in certain commodity costs;

Consumer spending;

Consumer debt levels;

New housing starts and completions;

Capital spending in the commercial construction market;

Access to liquidity needed for operations;

Seasonal nature of product sales;

Weather conditions;

Insurance coverage risks;

Federal, state and local regulations impacting our industry and products;

Prevailing interest rates;

Foreign currency exchange rate fluctuations;

International political risk; and

the continued viability of our business strategy.

In light of these uncertainties, there can be no assurance that the forward-looking information contained herein will be realized or, even if realized, in whole or in part, that the information will have the expected consequences to, or effects on, our business or operations. For additional information identifying other important factors that may affect our operations and could cause actual results to vary materially from those anticipated in the forward-looking statements, see our SEC filings, including but not limited to, the discussion included in Item 1A Risk Factors of our Annual Report on Form 10-K for the year ended December 31, 2013. Forward-looking statements speak only as of the date the statement was made. We assume no obligation to update forward-looking information or the discussion of such risks and uncertainties to reflect actual results, changes in assumptions or changes in other factors affecting forward-looking information, except as required by applicable law.

The following information should be read in conjunction with the condensed consolidated unaudited financial statements and notes thereto included under Item 1 of this Quarterly Report on Form 10-Q. In addition, reference should be made to our audited consolidated financial statements and notes thereto and the related Management's Discussion and Analysis of Financial Condition and Results of Operations included in our Annual Report on Form 10-K for the year ended December 31, 2013.

Company Overview

Watsco, Inc. was incorporated in Florida in 1956, and, together with its subsidiaries (collectively, *Watsco*, or *we*, *us* or *our*) is the largest distributor of air conditioning, heating and refrigeration equipment and related parts and supplies (HVAC/R) in the HVAC/R distribution industry in North America. At September 30, 2014, we operated from 574 locations in 38 U.S. States, Canada, Mexico and Puerto Rico with additional market coverage on an export basis to Latin America and the Caribbean.

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Revenues primarily consist of sales of air conditioning, heating and refrigeration equipment and related parts and supplies. Selling, general and administrative expenses primarily consist of selling expenses, the largest components of which are salaries, commissions and marketing expenses that are variable and correlate to changes in sales. Other significant selling, general and administrative expenses relate to the operation of warehouse facilities, including a fleet of trucks and forklifts and facility rent, which are payable mostly under non-cancelable operating leases.

Sales of residential central air conditioners, heating equipment and parts and supplies are seasonal. Furthermore, results of operations can be impacted favorably or unfavorably based on weather patterns, primarily during the summer and winter selling seasons. Demand related to the residential central air conditioning replacement market is typically highest in the second and third quarters, and demand for heating equipment is usually highest in the fourth quarter. Demand related to the new construction market is fairly consistent during the year, subject to weather and economic conditions, including their effect on the number of housing completions.

Joint Ventures with Carrier Corporation

In 2009, we formed a joint venture with Carrier Corporation (Carrier), which we refer to as Carrier Enterprise I, in which Carrier contributed 95 of its company-owned locations in 13 Sun Belt states and Puerto Rico and its export division in Miami, Florida, and we contributed 15 locations that distributed Carrier products. In July 2012, we exercised our option to acquire an additional 10% ownership interest in Carrier Enterprise I, which increased our ownership interest to 70%; and, on July 1, 2014, we exercised our option to acquire an additional 10% ownership interest in Carrier Enterprise I, which increased our controlling interest in Carrier Enterprise I to 80%. Neither we nor Carrier has any remaining options to purchase additional ownership interests in Carrier Enterprise I or any of our other joint ventures with Carrier.

In 2011, we formed a second joint venture with Carrier and completed two additional transactions. In April 2011, Carrier contributed 28 of its company-owned locations in eight Northeast U.S. States, and we contributed 14 locations in the Northeast U.S. In July 2011, we purchased Carrier's distribution operations in Mexico, which included seven locations. Collectively, the Northeast locations and the Mexico operations are referred to as Carrier Enterprise II. We have a 60% controlling interest in Carrier Enterprise II, and Carrier has a 40% noncontrolling interest.

In 2012, we formed a third joint venture, which we refer to as Carrier Enterprise III, with UTC Canada Corporation, referred to as UTC Canada, an affiliate of Carrier. Carrier contributed 35 of its company-owned locations in Canada to Carrier Enterprise III. We have a 60% controlling interest in Carrier Enterprise III, and UTC Canada has a 40% noncontrolling interest.

Critical Accounting Policies

Management's discussion and analysis of financial condition and results of operations is based upon the condensed consolidated unaudited financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the condensed consolidated unaudited financial statements and the reported amount of revenues and expenses during the reporting period. Actual results may differ from these estimates under different assumptions or conditions. At least quarterly, management reevaluates its judgments and estimates, which are based on historical experience, current trends and various other assumptions that are believed to be reasonable under the circumstances.

Our critical accounting policies are included in our 2013 Annual Report on Form 10-K as filed on February 27, 2014. We believe that there have been no significant changes during the quarter ended September 30, 2014 to the critical

accounting policies disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013.

New Accounting Standards

Refer to Note 1 to our condensed consolidated unaudited financial statements included in this Quarterly Report on Form 10-Q for a discussion of new accounting standards.

Table of Contents**Results of Operations**

The following table summarizes information derived from the condensed consolidated unaudited statements of income expressed as a percentage of revenues for the quarters and nine months ended September 30, 2014 and 2013:

| | Quarter Ended | | Nine Months | |
|--|-----------------------|--------|-----------------------------|--------|
| | September 30, 2014 | 2013 | Ended September 30, 2014 | 2013 |
| Revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 75.8 | 76.1 | 75.8 | 76.0 |
| Gross profit | 24.2 | 23.9 | 24.2 | 24.0 |
| Selling, general and administrative expenses | 14.9 | 15.1 | 15.9 | 16.1 |
| Operating income | 9.3 | 8.8 | 8.3 | 7.9 |
| Interest expense, net | 0.1 | 0.2 | 0.1 | 0.1 |
| Income before income taxes | 9.2 | 8.6 | 8.2 | 7.8 |
| Income taxes | 2.9 | 2.5 | 2.5 | 2.3 |
| Net income | 6.3 | 6.1 | 5.7 | 5.5 |
| Less: net income attributable to noncontrolling interest | 1.5 | 1.9 | 1.5 | 1.7 |
| Net income attributable to Watsco, Inc. | 4.8% | 4.2% | 4.2% | 3.8% |

In the following narratives, computations and disclosure information referring to same-store basis exclude the effects of locations acquired or locations opened or closed during the immediately preceding 12 months unless they are within close geographical proximity to existing locations. At September 30, 2014 and 2013, 21 and 20 locations, respectively, were excluded from same-store basis information. The table below summarizes the changes in our locations for the 12 months ended September 30, 2014:

| | Number of Locations |
|--------------------|--------------------------------|
| September 30, 2013 | 571 |
| Closed | (2) |
| December 31, 2013 | 569 |
| Opened | 12 |
| Closed | (7) |
| September 30, 2014 | 574 |

The following narratives also reflect our acquisition of an additional 10% ownership interest in Carrier Enterprise I, which became effective on July 1, 2014.

Third Quarter 2014 Compared to Third Quarter 2013

Revenues

Revenues for the quarter ended September 30, 2014 increased \$53.1 million, or 5%, compared to the same period in 2013, including \$0.1 million from locations opened during the preceding 12 months, partially offset by \$1.3 million from closed locations. On a same-store basis, revenues increased \$54.3 million, or 5%, as compared to the same period in 2013, reflecting a 7% increase in sales of HVAC equipment (65% of sales), which included a 7% increase in residential HVAC equipment and a 6% increase in commercial HVAC equipment, flat sales of other HVAC products (30% of sales) and a 14% increase in sales of commercial refrigeration products (5% of sales). The increase in same-store revenues is primarily due to higher demand for the replacement of residential HVAC equipment. Sales of residential HVAC equipment also benefited from an improved sales mix of higher-efficiency air conditioning and heating systems, which sell at higher unit prices.

Gross Profit

Gross profit for the quarter ended September 30, 2014 increased \$16.2 million, or 6%, compared to the same period in 2013, primarily as a result of increased revenues. Gross profit margin for the quarter ended September 30, 2014 improved 30 basis-points to 24.2% versus 23.9% for the same period in 2013, primarily due to higher realized gross margins for residential HVAC equipment.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the quarter ended September 30, 2014 increased \$6.4 million, or 4%, compared to the same period in 2013, primarily due to increased revenues and additional headcount. Selling, general and administrative expenses as a percent of revenues for the quarter ended September 30, 2014 decreased to 14.9% from 15.1% for the same period in 2013. The decrease in selling, general, and administrative expenses as a percentage of revenues was primarily due to improved leveraging of fixed operating costs as compared to 2013. On a same-store basis, selling, general and administrative expenses increased 4% as compared to the same period in 2013.

Table of Contents*Interest Expense, Net*

Net interest expense for the quarter ended September 30, 2014 decreased \$0.2 million, or 14%, compared to the same period in 2013, primarily as a result of a lower effective interest rate, partially offset by an increase in average outstanding borrowings in 2014 as compared to the same period in 2013.

Income Taxes

Income taxes increased to \$32.6 million for the quarter ended September 30, 2014 as compared to \$27.6 million for the quarter ended September 30, 2013 and are a composite of the income taxes attributable to our wholly owned operations and investments and income taxes attributable to the Carrier joint ventures, which are taxed as partnerships for income tax purposes. The effective income tax rate attributable to us was 36.8% and 37.0% for the quarters ended September 30, 2014 and 2013, respectively. The decrease was primarily due to lower state income taxes in 2014 versus 2013 related to income generated by our U.S. subsidiaries.

Net Income Attributable to Watsco, Inc.

Net income attributable to Watsco for the quarter ended September 30, 2014 increased \$8.8 million, or 19%, compared to the same period in 2013. The increase was primarily driven by higher revenues, expanded profit margins and reduced selling, general and administrative expenses as a percent of revenues, as discussed above, and by a reduction in the net income attributable to the noncontrolling interest related to Carrier Enterprise I following our purchase of an additional 10% ownership interest in Carrier Enterprise I in July 2014.

Nine Months Ended September 30, 2014 Compared to Nine Months Ended September 30, 2013*Revenues*

Revenues for the nine months ended September 30, 2014 increased \$151.8 million, or 5%, compared to the same period in 2013, including \$1.2 million from locations opened during the preceding 12 months, partially offset by \$3.7 million from closed locations. On a same-store basis, revenues increased \$154.3 million, or 5%, as compared to the same period in 2013. Revenues reflect a 7% increase in sales of HVAC equipment (64% of sales), which included an 8% increase in residential HVAC equipment and a 3% increase in commercial HVAC equipment, a 2% increase in sales of other HVAC products (31% of sales) and a 7% increase in sales of commercial refrigeration products (5% of sales). The increase in same-store revenues is primarily due to higher demand for the replacement of residential HVAC equipment. Sales of residential HVAC equipment also benefited from an improved sales mix of higher-efficiency air conditioning and heating systems, which sell at higher unit prices.

Gross Profit

Gross profit for the nine months ended September 30, 2014 increased \$41.4 million, or 6%, compared to the same period in 2013, primarily as a result of increased revenues. Gross profit margin for the nine months ended September 30, 2014 improved 20 basis-points to 24.2% versus 24.0% for the same period in 2013, primarily due to higher realized gross margins for residential HVAC equipment.

Selling, General and Administrative Expenses

Selling, general and administrative expenses for the nine months ended September 30, 2014 increased \$18.7 million, or 4%, compared to the same period in 2013, primarily as a result of increased revenues and additional headcount.

Selling, general and administrative expenses as a percent of revenues for the nine months ended September 30, 2014 decreased to 15.9% from 16.1% for the same period in 2013. The decrease in selling, general, and administrative expenses as a percentage of revenues was primarily due to improved leveraging of fixed operating costs as compared to 2013. On a same-store basis, selling, general, and administrative expenses increased 4% as compared to 2013.

Interest Expense, Net

Net interest expense for the nine months ended September 30, 2014 decreased \$0.9 million, or 19%, compared to the same period in 2013, primarily as a result of a decrease in average outstanding borrowings and a lower effective interest rate in 2014 as compared to 2013.

Income Taxes

Income taxes increased to \$76.1 million for the nine months ended September 30, 2014 as compared to \$66.7 million for the nine months ended September 30, 2013 and are a composite of the income taxes attributable to our wholly owned operations and investments and income taxes attributable to the Carrier joint ventures, which are taxed as partnerships for income tax purposes. The effective income tax rate attributable to us was 36.8% and 37.0% for the nine months ended September 30, 2014 and 2013, respectively. The decrease was primarily due to lower state income taxes in 2014 versus 2013 related to income generated by our U.S. subsidiaries.

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Net Income Attributable to Watsco, Inc.

Net income attributable to Watsco for the nine months ended September 30, 2014 increased \$16.9 million, or 15%, compared to the same period in 2013. The increase was primarily driven by higher revenues, expanded profit margins and reduced selling, general and administrative expenses as a percent of revenues, as discussed above, and by a reduction in the net income attributable to the noncontrolling interest related to Carrier Enterprise I following our purchase of an additional 10% ownership interest in Carrier Enterprise I in July 2014.

Liquidity and Capital Resources

We assess our liquidity in terms of our ability to generate cash to execute our business strategy and fund operating and investing activities, taking into consideration the seasonal demand for HVAC/R products, which peaks in the months of May through August. Significant factors that could affect our liquidity include the following:

cash necessary to fund our business (primarily working capital requirements);

the adequacy of our available bank line of credit;

the ability to attract long-term capital with satisfactory terms;

acquisitions, including joint ventures;

dividend payments;

capital expenditures; and

the timing and extent of common stock repurchases.

Sources and Uses of Cash

We rely on cash flows from operations and borrowing capacity under our revolving credit agreement to fund seasonal working capital needs and for other general corporate purposes, including dividend payments, if and as declared by our Board of Directors, capital expenditures, business acquisitions and development of our long-term operating strategies.

At September 30, 2014, we had \$16.7 million of cash and cash equivalents, of which, \$12.1 million was held by foreign subsidiaries. We believe that our operating cash flows, cash on hand and funds available for borrowing under our line of credit will be sufficient to meet our liquidity needs in the foreseeable future. However, there can be no assurance that our current sources of available funds will be sufficient to meet our cash requirements.

Our access to funds under our line of credit depends on the ability of the syndicate banks to meet their respective funding commitments. Disruptions in the capital and credit markets could adversely affect our ability to draw on our line of credit and may also adversely affect the determination of interest rates, particularly rates based on LIBOR, which is one of the base rates under our line of credit. Disruptions in the capital and credit markets could also result in increased borrowing costs and/or reduced borrowing capacity under our line of credit.

Working Capital

Working capital increased to \$930.6 million at September 30, 2014 from \$777.6 million at December 31, 2013, reflecting higher levels of accounts receivable and inventories, primarily due to the seasonality of our business.

Cash Flows

The following table summarizes our cash flow activity for the nine months ended September 30, 2014 and 2013 (in millions):

| | 2014 | 2013 | Change |
|---|-----------|-----------|----------|
| Cash flows provided by operating activities | \$ 41.7 | \$ 51.2 | \$ (9.5) |
| Cash flows used in investing activities | \$ (8.9) | \$ (10.7) | \$ 1.8 |
| Cash flows used in financing activities | \$ (35.4) | \$ (84.7) | \$ 49.3 |

The individual items contributing to cash flow changes for the periods presented are detailed in the condensed consolidated unaudited statements of cash flows contained in this Quarterly Report on Form 10-Q.

Operating Activities

The decrease in net cash provided by operating activities was primarily due to higher accounts receivable driven by increased sales and higher levels of inventory in 2014 as compared to 2013, partially offset by higher net income in 2014 as compared to 2013 and the timing of payments for accrued expenses.

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Investing Activities

The decrease in net cash used in investing activities was due to lower capital expenditures in 2014 as compared to 2013.

Financing Activities

The decrease in net cash used in financing activities was primarily attributable to higher net borrowings under our revolving credit agreement, partially offset by the exercise of our second option to acquire an additional 10% ownership interest in Carrier Enterprise I for \$87.7 million and a decrease in distributions to the noncontrolling interest in 2014 and an increase in dividends paid in 2014 as compared to 2013.

Revolving Credit Agreement

We maintain an unsecured, syndicated revolving credit agreement, which we use to fund seasonal working capital needs and other general corporate purposes, including acquisitions, dividends, stock repurchases and issuances of letters of credit. On June 25, 2014, we entered into an amendment to this credit agreement, which increased the borrowing capacity from \$500.0 million to \$600.0 million, extended the maturity date from July 1, 2018 to July 1, 2019, increased the swingline subfacility from \$65.0 million to \$90.0 million and modified certain definitions. At September 30, 2014 and December 31, 2013, \$352.0 million and \$230.0 million were outstanding under the revolving credit agreement, respectively. The revolving credit agreement contains customary affirmative and negative covenants, including financial covenants with respect to consolidated leverage and interest coverage ratios, and other customary restrictions. We believe we were in compliance with all such covenants at September 30, 2014.

Purchase of Ownership Interest in Joint Venture

On July 1, 2014, we exercised our second option to acquire an additional 10% ownership interest in Carrier Enterprise I for cash consideration of \$87.7 million, following which we have an 80% controlling interest in Carrier Enterprise I. Neither we nor Carrier has any remaining options to purchase additional ownership interests in Carrier Enterprise I, or any of our other joint ventures with Carrier.

Acquisitions

We continually evaluate potential acquisitions and/or joint ventures and routinely hold discussions with a number of acquisition candidates. Should suitable acquisition opportunities arise that would require additional financing, we believe our financial position and earnings history provide a sufficient basis for us to either obtain additional debt financing at competitive rates and on reasonable terms or raise capital through the issuance of equity securities.

Common Stock Dividends

We paid cash dividends of \$1.40 per share and \$0.75 per share of Common stock and Class B common stock during the nine months ended September 30, 2014 and 2013, respectively. On October 1, 2014, our Board of Directors declared a regular quarterly cash dividend of \$0.60 per share of Common and Class B common stock that was paid on October 31, 2014 to shareholders of record as of October 15, 2014. Future dividends and/or dividend rate increases will be at the sole discretion of the Board of Directors and will depend upon such factors as cash flow generated by operations, profitability, financial condition, cash requirements, future prospects and other factors deemed relevant by our Board of Directors.

Company Share Repurchase Program

In September 1999, our Board of Directors authorized the repurchase, at management's discretion, of up to 7,500,000 shares of common stock in the open market or via private transactions. Shares repurchased under the program are accounted for using the cost method and result in a reduction of shareholders' equity. No shares were repurchased during the quarters ended September 30, 2014 or 2013. In aggregate, 6,370,913 shares of Common and Class B common stock have been repurchased at a cost of \$114.4 million since the inception of the program. At September 30, 2014, there were 1,129,087 shares remaining authorized for repurchase under the program.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risk from the information provided in Item 7A, Quantitative and Qualitative Disclosures about Market Risk, of our Annual Report on Form 10-K for the year ended December 31, 2013.

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ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

We maintain disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) that are, among other things, designed to ensure that information required to be disclosed by us under the Exchange Act is accumulated and communicated to management, including our Chief Executive Officer (CEO), Senior Vice President (SVP) and Chief Financial Officer (CFO), to allow for timely decisions regarding required disclosure and appropriate SEC filings.

Our management, with the participation of our CEO, SVP and CFO, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report, and, based on that evaluation, our CEO, SVP and CFO concluded that our disclosure controls and procedures were effective, at a reasonable assurance level, at and as of such date.

Changes in Internal Control over Financial Reporting

We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout the Company. However, there were no changes in internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2014, 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

Information with respect to this item may be found in Note 9 to our condensed consolidated unaudited financial statements contained in this Quarterly Report on Form 10-Q under the caption Litigation, Claims and Assessments, which information is incorporated by reference in this Item 1 of Part II of this Quarterly Report on Form 10-Q.

ITEM 1A. RISK FACTORS

Information about risk factors for the quarter ended September 30, 2014 does not differ materially from that set forth in Part I, Item 1A, of our Annual Report on Form 10-K for the year ended December 31, 2013.

ITEM 6. EXHIBITS

- 31.1 # Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 # Certification of Senior Vice President pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.3 # Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a- 15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

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|-----------|--|
| 32.1 + | Certification of Chief Executive Officer, Senior Vice President and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes- Oxley Act of 2002. |
| 101.INS # | XBRL Instance Document. |
| 101.SCH # | XBRL Taxonomy Extension Schema Document. |
| 101.CAL # | XBRL Taxonomy Extension Calculation Linkbase Document. |
| 101.DEF # | XBRL Taxonomy Extension Definition Linkbase Document. |
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filed herewith.

+ furnished herewith.

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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.

WATSCO, INC.
(Registrant)

November 4, 2014

By: /s/ Ana M. Menendez
Ana M. Menendez
Chief Financial Officer
(on behalf of the Registrant and as Principal Financial Officer)

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Table of Contents**INDEX TO EXHIBITS**

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