

AAON INC
Form 10-Q
May 02, 2019

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2019

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: 0-18953

AAON, INC.

(Exact name of registrant as specified in its charter)

Nevada 87-0448736

(State or other jurisdiction (IRS Employer
of incorporation or organization) Identification No.)

2425 South Yukon, Tulsa, Oklahoma 74107

(Address of principal executive offices) (Zip Code)

(918) 583-2266

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

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

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

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

| Title of each class | Trading Symbol(s) | Name of each exchange on which registered |
|---------------------|-------------------|---|
| Common Stock | AAON | NASDAQ |

As of April 30, 2019, registrant had outstanding a total of 52,115,261 shares of its \$.004 par value Common Stock.

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements.
AAON, Inc. and Subsidiaries
Consolidated Balance Sheets
(Unaudited)

| | March 31, December 31, 2019 2018 | |
|---|---|------------|
| | (in thousands, except share and per share data) | |
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$7,143 | \$ 1,994 |
| Accounts receivable, net | 58,688 | 54,078 |
| Income tax receivable | 4,756 | 6,104 |
| Note receivable | 27 | 27 |
| Inventories, net | 74,577 | 77,612 |
| Prepaid expenses and other | 1,607 | 1,046 |
| Total current assets | 146,798 | 140,861 |
| Property, plant and equipment: | | |
| Land | 3,114 | 3,114 |
| Buildings | 98,394 | 97,393 |
| Machinery and equipment | 215,928 | 212,779 |
| Furniture and fixtures | 17,079 | 16,597 |
| Total property, plant and equipment | 334,515 | 329,883 |
| Less: Accumulated depreciation | 167,863 | 166,880 |
| Property, plant and equipment, net | 166,652 | 163,003 |
| Intangible assets, net | 447 | 506 |
| Goodwill | 3,229 | 3,229 |
| Right of use assets | 1,796 | — |
| Note receivable | 603 | 598 |
| Total assets | \$319,525 | \$ 308,197 |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Revolving credit facility | \$— | \$ — |
| Accounts payable | 5,947 | 10,616 |
| Accrued liabilities | 38,053 | 37,455 |
| Total current liabilities | 44,000 | 48,071 |
| Deferred tax liabilities | 12,713 | 10,826 |
| Other long-term liabilities | 3,442 | 1,801 |
| Commitments and contingencies | | |
| Stockholders' equity: | | |
| Preferred stock, \$.001 par value, 5,000,000 shares authorized, no shares issued | — | — |
| Common stock, \$.004 par value, 100,000,000 shares authorized, 52,099,274 and 51,991,242 issued and outstanding at March 31, 2019 and December 31, 2018, respectively | 208 | 208 |
| Additional paid-in capital | 969 | — |
| Retained earnings | 258,193 | 247,291 |
| Total stockholders' equity | 259,370 | 247,499 |

Total liabilities and stockholders' equity

\$319,525 \$ 308,197

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

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AAON, Inc. and Subsidiaries
 Consolidated Statements of Income
 (Unaudited)

| | Three Months Ended March 31, | |
|--|---|------------|
| | 2019 | 2018 |
| | (in thousands, except share and per share data) | |
| Net sales | \$ 113,822 | \$ 99,082 |
| Cost of sales | 88,029 | 83,692 |
| Gross profit | 25,793 | 15,390 |
| Selling, general and administrative expenses | 11,001 | 10,219 |
| Loss (gain) on disposal of assets | 284 | (7) |
| Income from operations | 14,508 | 5,178 |
| Interest income, net | 9 | 68 |
| Other expense, net | (26) | (6) |
| Income before taxes | 14,491 | 5,240 |
| Income tax provision | 3,589 | 980 |
| Net income | \$ 10,902 | \$ 4,260 |
| Earnings per share: | | |
| Basic | \$ 0.21 | \$ 0.08 |
| Diluted | \$ 0.21 | \$ 0.08 |
| Weighted average shares outstanding: | | |
| Basic | 51,992,150 | 52,433,902 |
| Diluted | 52,369,660 | 52,910,223 |

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

AAON, Inc. and Subsidiaries
 Consolidated Statements of Stockholders' Equity
 (Unaudited)

| | Common Stock Shares | Amount | Paid-in Capital | Retained Earnings | Total |
|--|------------------------|--------|--------------------|----------------------|-----------|
| | (in thousands) | | | | |
| Balances at December 31, 2018 | 51,991 | \$ 208 | \$ — | \$247,291 | \$247,499 |
| Net income | — | — | — | 10,902 | 10,902 |
| Stock options exercised and restricted stock awards granted | 237 | 1 | 4,009 | — | 4,010 |
| Share-based compensation | — | — | 2,030 | — | 2,030 |
| Stock repurchased and retired | (129) | (1) | (5,070) | — | (5,071) |
| Balances at March 31, 2019 | 52,099 | \$ 208 | \$ 969 | \$258,193 | \$259,370 |

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

AAON, Inc. and Subsidiaries
Consolidated Statements of Cash Flows
(Unaudited)

| | Three Months Ended March 31, | |
|---|------------------------------------|----------|
| | 2019 | 2018 |
| | (in thousands) | |
| Operating Activities | | |
| Net income | \$ 10,902 | \$ 4,260 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 5,914 | 4,129 |
| Amortization of bond premiums | — | 5 |
| Provision for losses on accounts receivable, net of adjustments | 115 | (11) |
| Provision for excess and obsolete inventories | 357 | 101 |
| Share-based compensation | 2,030 | 1,724 |
| Loss (gain) on disposition of assets | 284 | (7) |
| Foreign currency transaction gain | (16) | 3 |
| Interest income on note receivable | (6) | 9 |
| Deferred income taxes | 1,887 | 420 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (4,725) | (2,897) |
| Income taxes | 1,348 | (5,673) |
| Inventories | 2,678 | 3,447 |
| Prepaid expenses and other | (561) | (712) |
| Accounts payable | (5,730) | 9,833 |
| Deferred revenue | 25 | 37 |
| Accrued liabilities and donations | 411 | (3,924) |
| Net cash provided by operating activities | 14,913 | 10,744 |
| Investing Activities | | |
| Capital expenditures | (8,772) | (8,451) |
| Cash paid in business combination | — | (6,000) |
| Proceeds from sale of property, plant and equipment | 52 | 6 |
| Investment in certificates of deposits | — | (4,320) |
| Maturities of certificates of deposits | — | 1,200 |
| Purchases of investments held to maturity | — | (7,495) |
| Maturities of investments | — | 4,230 |
| Proceeds from called investments | — | 395 |
| Principal payments from note receivable | 17 | 14 |
| Net cash used in investing activities | (8,703) | (20,421) |
| Financing Activities | | |
| Stock options exercised | 4,010 | 1,340 |
| Repurchase of stock | (4,483) | (4,379) |
| Employee taxes paid by withholding shares | (588) | (568) |
| Net cash used in financing activities | (1,061) | (3,607) |
| Net increase (decrease) in cash and cash equivalents | 5,149 | (13,284) |
| Cash and cash equivalents, beginning of period | 1,994 | 21,457 |
| Cash and cash equivalents, end of period | \$ 7,143 | \$ 8,173 |

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

AAON, Inc. and Subsidiaries
Notes to the Consolidated Financial Statements
(Unaudited)

1. General

Basis of Presentation

The accompanying unaudited consolidated financial statements of AAON, Inc., a Nevada corporation, and our operating subsidiaries, all of which are wholly-owned, (collectively, the “Company”) have been prepared in accordance with U.S. generally accepted accounting principles (“U.S. GAAP”) for interim financial information and with the rules and regulations of the Securities and Exchange Commission (“SEC”). These financial statements have not been audited by the Company's independent registered public accounting firm, except that the consolidated balance sheet at December 31, 2018 is derived from audited consolidated financial statements. Accordingly, they do not include all of the information and notes required by U.S. GAAP for complete financial statements. The financial statements reflect all adjustments (all of which are of a normal recurring nature) which are, in the opinion of management, necessary for a fair statement of the results for the interim periods presented. Interim results are not necessarily indicative of the results that may be expected for a full year. Certain disclosures have been condensed in or omitted from these consolidated financial statements. The accompanying unaudited financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2018. All intercompany balances and transactions have been eliminated in consolidation.

We are engaged in the engineering, manufacturing, marketing and sale of air conditioning and heating equipment consisting of standard, semi-custom and custom rooftop units, chillers, packaged outdoor mechanical rooms, air handling units, makeup air units, energy recovery units, condensing units, geothermal/water-source heat pumps, coils and controls.

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and 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. Because these estimates and assumptions require significant judgment, actual results could differ from those estimates and could have a significant impact on our results of operations, financial position and cash flows. We reevaluate our estimates and assumptions as needed, but at a minimum on a quarterly basis. The most significant estimates include, but are not limited to, the fair-value of acquisitions, inventory reserves, warranty accrual, worker's compensation accrual, medical insurance accrual, income taxes and share-based compensation. Actual results could differ materially from those estimates.

Accounting Policies

A comprehensive discussion of our critical accounting policies and management estimates is included in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2018.

Business Combinations

We record the assets acquired and liabilities assumed in a business combination at their acquisition date fair values.

Fair Value Measurements

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. Fair value is based upon assumptions that market participants would use when pricing an asset or liability. We use the following fair value hierarchy, which prioritizes valuation technique inputs used to measure fair value into three broad levels:

Level 1: Quoted prices in active markets for identical assets and liabilities that we have the ability to access at the measurement date.

Level 2: Inputs (other than quoted prices included within Level 1) that are either directly or indirectly observable for the asset or liability, including (i) quoted prices for similar assets or liabilities in active markets, (ii) quoted prices for identical or similar assets or liabilities in inactive markets, (iii) inputs other than quoted prices that are observable for the asset or liability, and (iv) inputs that are derived from observable market data by correlation or other means.

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Level 3: Unobservable inputs for the asset or liability including situations where there is little, if any, market activity for the asset or liability. Items categorized in Level 3 include the estimated business combination fair values of property, plant and equipment, intangible assets and goodwill.

The fair value hierarchy gives the highest priority to quoted prices in active markets (Level 1) and the lowest priority to unobservable inputs (Level 3). In some cases, the inputs used to measure fair value might fall into different levels of the fair value hierarchy. The lowest level input that is significant to a fair value measurement determines the applicable level in the fair value hierarchy. Assessing the significance of a particular input to a fair value measurement requires judgment, considering factors specific to the asset or liability.

Intangible Assets

Our intangible assets include various trademarks, service marks and technical knowledge acquired in our February 2018 business combination (see Note 3). We amortize our intangible assets on a straight-line basis over the estimated useful lives of the assets. We evaluate the carrying value of our amortizable intangible assets for potential impairment when events and circumstances warrant such a review.

Goodwill

Goodwill represents the excess of the consideration paid for the acquired businesses over the fair value of the individual assets acquired, net of liabilities assumed. Goodwill at March 31, 2019 is deductible for income tax purposes. Goodwill is not amortized, but instead is evaluated for impairment at least annually. We perform our annual assessment of impairment during the fourth quarter of our fiscal year, and more frequently if circumstances warrant.

Recent Accounting Pronouncements

Changes to U.S. GAAP are established by the Financial Accounting Standards Board ("FASB") in the form of Accounting Standards Updates ("ASUs") to the FASB's Accounting Standards Codification ("ASC").

We consider the applicability and impact of all ASUs. ASUs not listed below were assessed and determined to be either not applicable or are expected to have minimal impact on our consolidated financial statements and notes thereto.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurements: Changes to the Disclosure Requirement for Fair Value Measurements. The ASU includes additional disclosure requirements for unrealized gains and losses for Level 3 fair value measurement and significant observable inputs used to develop Level 3 fair value measurements. The ASU is effective for the Company beginning after December 15, 2019. We do not expect ASU 2018-13 will have a material effect on our consolidated financial statements and notes thereto.

2. Revenue Recognition

On January 1, 2018, we adopted the new accounting standard FASB ASC 606, Revenue from Contracts with Customers, and all the related amendments to all contracts using the retrospective method. The impact at adoption was not material to the consolidated financial statements. The new accounting policy provides results substantially consistent with prior revenue recognition policies.

Disaggregated net sales by major source:

| | Three months ended March 31, | |
|--------------------------|------------------------------------|----------|
| | 2019 | 2018 |
| Rooftop Units | \$88,343 | \$74,815 |
| Condensing Units | 4,050 | 4,281 |
| Air Handlers | 5,594 | 5,240 |
| Outdoor Mechanical Rooms | 482 | 973 |
| Water Source Heat Pumps | 5,844 | 4,387 |
| Part Sales | 6,490 | 5,960 |
| Other | 3,019 | 3,426 |
| Net Sales | \$113,822 | \$99,082 |

Disaggregated units sold by major source:

| | Three months ended March 31, | |
|--------------------------|---------------------------------------|-------|
| | 2019 | 2018 |
| Rooftop Units | 3,762 | 3,468 |
| Condensing Units | 394 | 411 |
| Air Handlers | 580 | 536 |
| Outdoor Mechanical Rooms | 11 | 14 |
| Water Source Heat Pumps | 2,289 | 1,614 |
| Total Units | 7,036 | 6,043 |

The Company recognizes revenue when it satisfies the performance obligation in its contracts. Most of the Company's products are highly customized, cannot be resold to other customers and the cost of rework to be resold is not economical. The Company has a formal cancellation policy and generally does not accept returns on these units. As a result, many of the Company's products do not have an alternative use and therefore, for these products we recognize revenue over the time it takes to produce the unit. For all other products that are part sales or standardized units, we satisfy the performance obligation when the title and risk of ownership pass to the customer, generally at time of shipment. Final sales prices are fixed based on purchase orders. Sales allowances and customer incentives are treated as reductions to sales and are provided for based on historical experiences and current estimates. Sales of our products are moderately seasonal with the peak period being July - November of each year.

In addition, the Company presents revenues net of sales tax and net of certain payments to our independent manufacturer representatives ("Representatives"). Representatives are national companies that are in the business of providing HVAC units and other related products and services to customers. The end user customer orders a bundled group of products and services from the Representative and expects the Representative to fulfill the order. Only after the specifications are agreed to by the Representative and the customer, and the decision is made to use an AAON HVAC unit, will we receive notice of the order. We establish the amount we must receive for our HVAC unit ("minimum sales price"), but do not control the total order price that is negotiated by the Representative with the end user customer.

We are responsible for billings and collections resulting from all sales transactions, including those initiated by our Representatives. The Representatives submit the total order price to us for invoicing and collection. The total order price includes our minimum sales price and an additional amount which may include both the Representatives' fee and

amounts due for additional products and services required by the customer. These additional products and services may include controls purchased from another manufacturer to operate the unit, start-up services, and curbs for supporting the unit (“Third Party Products”). All are associated with the purchase of a HVAC unit but may be provided by the Representative or another third party. The Company is under no obligation related to Third Party Products.

The Representatives’ fee and Third Party Products amounts (“Due to Representatives”) are paid only after all amounts associated with the order are collected from the customer. The amount of payments to our Representatives were \$11.5 million and \$11.6 million for the three months ended March 31, 2019 and 2018, respectively.

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The Company also sells extended warranties on parts for various lengths of time ranging from six months to 10 years. Revenue for these separately priced warranties is deferred and recognized on a straight-line basis over the separately priced warranty period.

3. Business Combination

On February 28, 2018, we closed on the purchase of substantially all of the assets of WattMaster Controls, Inc., (“WattMaster”). The assets acquired consisted primarily of intellectual property, receivables, inventory and fixed assets. The Company also hired substantially all of the WattMaster employees. These assets and workforce have allowed us to accelerate the development of our own electronic controllers for air distribution systems. We funded the business combination with available cash of \$6.0 million. We paid the final working capital settlement of \$0.4 million with available cash in May 2018. We have included the results of WattMaster’s operations in our consolidated financial statements beginning March 1, 2018.

The following table presents the allocation of the consideration paid to the assets acquired and liabilities assumed, based on their fair values, in the acquisition of WattMaster described above:

| | |
|-------------------------------|-------------------|
| | (in thousands) |
| Accounts receivable | \$ 1,082 |
| Inventories | 1,380 |
| Property, plant and equipment | 340 |
| Intellectual property | 700 |
| Goodwill | 3,229 |
| Assumed current liabilities | (354) |
| Consideration paid | \$ 6,377 |

Goodwill represents the excess of the consideration paid for the acquired businesses over the fair value of the individual assets acquired, net of liabilities assumed. Goodwill represents a premium paid to acquire the skilled workforce of the business acquired and is deductible for federal income tax purposes.

4. Leases

We adopted ASU No. 2016-02, Leases (Topic 842), as amended, as of January 1, 2019, using the transition method, which becomes effective upon the date of adoption. The transition method allows entities to initially apply the new leases standard at the adoption date (January 1, 2019) and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. In addition, we elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed us to carry forward the historical lease classification. We have also elected the short-term lease measurement and recognition exemption which does not require balance sheet presentation for short-term leases. The Company historically does not enter into numerous or material lease agreements to support its manufacturing operations. Furthermore, any lease agreements entered into are usually less than a year and for leases on non material assets such as warehouse vehicles and office equipment.

Adoption of the new standard resulted in the recording of additional lease right of use assets and lease liabilities of approximately \$1.8 million, respectively, as of January 1, 2019, which mostly relates to the multi-year facility lease assumed in the 2018 WattMaster acquisition. The cumulative-effect adjustments to the opening balance was immaterial to the consolidated financial statements as a whole. The standard did not materially impact our consolidated net earnings or cash flows.

5. Accounts Receivable

Accounts receivable and the related allowance for doubtful accounts are as follows:

| | March 31, 2019 | December 31, 2018 | |
|---|-------------------|----------------------|-----------------------|
| | (in thousands) | | |
| Accounts receivable | \$59,067 | \$ 54,342 | |
| Less: Allowance for doubtful accounts | (379) | (264) | |
| Total, net | \$58,688 | \$ 54,078 | |
| | | | Three months ended |
| | | | March 31, 2019 |
| | | | March 31, 2018 |
| | (in thousands) | | |
| Allowance for doubtful accounts: | | | |
| Balance, beginning of period | \$264 | \$ 119 | |
| Provisions for losses on accounts receivables, net of adjustments | 115 | (11) | |
| Balance, end of period | \$379 | \$ 108 | |

6. Inventories

Inventories are valued at the lower of cost or net realizable value. Cost is determined by the first-in, first-out (“FIFO”) method. We establish an allowance for excess and obsolete inventories based on product line changes, the feasibility of substituting parts and the need for supply and replacement parts.

The components of inventories are as follows:

| | March 31, 2019 | December 31, 2018 | |
|---|-------------------|----------------------|--|
| | (in thousands) | | |
| Raw materials | \$67,519 | \$ 67,995 | |
| Work in process | 3,131 | 4,060 | |
| Finished goods | 5,494 | 6,767 | |
| | 76,144 | 78,822 | |
| Less: Allowance for excess and obsolete inventories | (1,567) | (1,210) | |
| Total, net | \$74,577 | \$ 77,612 | |

The related changes in the allowance for excess and obsolete inventories account are as follows:

| | Three months ended | |
|--|-----------------------|-------------------|
| | March 31, 2019 | March 31, 2018 |
| | (in thousands) | |
| Allowance for excess and obsolete inventories: | | |
| Balance, beginning of period | \$1,210 | \$ 1,118 |
| Provisions for excess and obsolete inventories | 357 | 101 |
| Inventories written off | — | (10) |
| Balance, end of period | \$1,567 | \$ 1,209 |

7. Intangible Assets

Our intangible assets consist of the following:

| | March 2019 | December 31, 2018 |
|--------------------------------|----------------|-------------------|
| | (in thousands) | |
| Intellectual property | \$700 | \$ 700 |
| Less: Accumulated amortization | (253) | (194) |
| Total, net | \$447 | \$ 506 |

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Amortization expense recorded in cost of sales is as follows:

| | Three months ended March 31, 2019 2018 (in thousands) | |
|----------------------|---|------|
| Amortization expense | \$ 59 | \$ — |

8. Supplemental Cash Flow Information

| | Three months ended March 31, 2019 2018 (in thousands) | |
|--|---|----------|
| Supplemental disclosures: | | |
| Interest paid | \$— | \$ 5 |
| Income taxes paid | \$353 | \$ 6,232 |
| Non-cash investing and financing activities: | | |
| Non-cash capital expenditures | \$ 1,068 | \$ 733 |

9. Warranties

The Company has warranties with various terms ranging from 18 months for parts to 25 years for certain heat exchangers. The Company has an obligation to replace parts if conditions under the warranty are met. A provision is made for estimated warranty costs at the time the related products are sold based upon the warranty period, historical trends, new products and any known identifiable warranty issues.

Changes in the warranty accrual are as follows:

| | Three months ended March 31, March 31, 2019 2018 (in thousands) | |
|------------------------------|--|-----------|
| Warranty accrual: | | |
| Balance, beginning of period | \$ 11,421 | \$ 10,483 |
| Payments made | (1,106) | (1,222) |
| Provisions | 1,109 | 1,527 |
| Balance, end of period | \$ 11,424 | \$ 10,788 |
| Warranty expense: | \$ 1,109 | \$ 1,527 |

10. Accrued Liabilities

Accrued liabilities were comprised of the following:

| | March 31, 2019 | December 31, 2018 |
|------------------------|----------------|-------------------|
| | (in thousands) | |
| Warranty | \$ 11,424 | \$ 11,421 |
| Due to representatives | 11,154 | 11,024 |
| Payroll | 4,659 | 4,182 |
| Profit sharing | 1,644 | 1,835 |
| Worker's compensation | 504 | 567 |
| Medical self-insurance | 1,010 | 1,207 |
| Customer prepayments | 1,725 | 2,367 |
| Employee vacation time | 3,563 | 3,173 |
| Other | 2,370 | 1,679 |
| Total | \$38,053 | \$ 37,455 |

11. Revolving Credit Facility

Our revolving credit facility, as amended, provides for maximum borrowings of \$30.0 million, which is provided by BOKF, NA dba Bank of Oklahoma (“Bank of Oklahoma”). Under the line of credit, there is one standby letter of credit totaling \$1.3 million. Borrowings available under the revolving credit facility at March 31, 2019 were \$28.7 million. Interest on borrowings is payable monthly at LIBOR plus 2.0%. No fees are associated with the unused portion of the committed amount. We had no outstanding balance under the revolving credit facility at March 31, 2019 and December 31, 2018. The revolving credit facility expires on July 26, 2021.

As of March 31, 2019, we were in compliance with our financial covenants. These covenants require that we meet certain parameters related to our tangible net worth and total liabilities to tangible net worth ratio. At March 31, 2019, our tangible net worth was \$259.4 million and met the requirement of being at or above \$175.0 million. Our total liabilities to tangible net worth ratio was 0.2 to 1, and met the requirement of not being above 2 to 1.

12. Income Taxes

The provision (benefit) for income taxes consists of the following:

| | Three months ended March 31, 2019 | March 31, 2018 |
|----------|-----------------------------------|----------------|
| | (in thousands) | |
| Current | \$ 1,702 | \$ 560 |
| Deferred | 1,887 | 420 |
| | \$3,589 | \$ 980 |

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate before the provision for income taxes.

The reconciliation of the Federal statutory income tax rate to the effective income tax rate is as follows:

| | Three months ended | |
|--|-----------------------|-------------------|
| | March 31, 2019 | March 31, 2018 |
| Federal statutory rate | 21.0 % | 21.0 % |
| State income taxes, net of Federal benefit | 6.1 | 6.8 |
| Excess tax benefits | (2.7) | (8.9) |
| Other | 0.4 | (0.2) |
| Effective tax rate | 24.8 % | 18.7 % |

The Company's estimated annual 2019 effective tax rate, excluding discrete events, is approximately 27%. We file income tax returns in the U.S., state and foreign income tax returns jurisdictions. We are subject to U.S. examinations for tax years 2014 to present, and to non-U.S. income tax examinations for the tax years of 2014 to present. In addition, we are subject to state and local income tax examinations for the tax years 2014 to present. The Company continues to evaluate its need to file returns in various state jurisdictions. Any interest or penalties would be recognized as a component of income tax expense.

13. Share-Based Compensation

On May 22, 2007, our stockholders adopted a Long-Term Incentive Plan ("LTIP") which provided an additional 3.3 million shares that could be granted in the form of stock options, stock appreciation rights, restricted stock awards, performance units and performance awards, in addition to the shares from the previous plan, the 1992 Plan. Since inception of the LTIP, non-qualified stock options and restricted stock awards have been granted with a five year vesting schedule. Under the LTIP, the exercise price of shares granted could not be less than 100% of the fair market value at the date of the grant.

On May 24, 2016, our stockholders adopted the 2016 Long-Term Incentive Plan ("2016 Plan") which provides for approximately 6.4 million shares, comprised of 3.4 million new shares provided for under the 2016 Plan, approximately 0.4 million shares that were available for issuance under the previous LTIP that are now authorized for issuance under the 2016 Plan, and an additional 2.6 million shares that were approved by the stockholders on May 15, 2018. Under the 2016 Plan, shares can be granted in the form of stock options, stock appreciation rights, restricted stock awards, performance awards, dividend equivalent rights, and other awards. Under the 2016 Plan, the exercise price of shares granted may not be less than 100% of the fair market value at the date of the grant. The 2016 Plan will be administered by the Compensation Committee of the Board of Directors or such other committee of the Board of Directors as is designated by the Board of Directors (the "Committee"). Membership on the Committee shall be limited to independent directors. The Committee may delegate certain duties to one or more officers of the Company as provided in the 2016 Plan. The Committee will determine the persons to whom awards are to be made, determine the type, size and terms of awards, interpret the 2016 Plan, establish and revise rules and regulations relating to the 2016 Plan and make any other determinations that it believes necessary for the administration of the 2016 Plan.

Options - The total pre-tax compensation cost related to unvested stock options not yet recognized as of March 31, 2019 is \$32.6 million and is expected to be recognized over a weighted average period of 4.23 years.

The following weighted average assumptions were used to determine the fair value of the stock options granted on the original grant date for expense recognition purposes for options granted during the three months ended March 31, 2019 and 2018 using a Black Scholes-Merton Model:

| | Three months ended | |
|--------------------------|--------------------|----------------|
| | March 31, 2019 | March 31, 2018 |
| Directors and Officers: | | |
| Expected dividend rate | \$0.32 | \$ 0.26 |
| Expected volatility | 29.54 % | 29.73 % |
| Risk-free interest rate | 2.40 % | 2.20 % |
| Expected life (in years) | 5.0 | 5.0 |

Employees:

| | | |
|--------------------------|---------|---------|
| Expected dividend rate | \$0.32 | \$ 0.26 |
| Expected volatility | 29.54 % | 29.82 % |
| Risk-free interest rate | 2.40 % | 2.48 % |
| Expected life (in years) | 5.0 | 5.0 |

The expected term of the options is based on evaluations of historical and expected future employee exercise behavior. The risk-free interest rate is based on the U.S. Treasury rates at the date of grant with maturity dates approximately equal to the expected life at the grant date. Volatility is based on historical volatility of our stock over time periods equal to the expected life at grant date.

The following is a summary of stock options vested and exercisable as of March 31, 2019:

| Range of Exercise Prices | Number of Shares | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Intrinsic Value (in thousands) |
|--------------------------|------------------|--|---------------------------------|--------------------------------|
| \$6.13 - \$33.20 | 496,465 | 6.11 | \$ 22.56 | \$ 11,727 |
| \$33.40 - \$40.87 | 187,024 | 8.28 | 35.53 | 1,991 |
| \$41.37 - \$46.18 | — | — | — | — |
| Total | 683,489 | 6.70 | \$ 26.11 | \$ 13,718 |

The following is a summary of stock options vested and exercisable as of March 31, 2018:

| Range of Exercise Prices | Number of Shares | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Intrinsic Value (in thousands) |
|--------------------------|------------------|--|---------------------------------|--------------------------------|
| \$4.54 - \$32.80 | 486,601 | 5.19 | \$ 16.32 | \$ 11,036 |
| \$32.85 - \$34.10 | 65,054 | 5.64 | 34.06 | 322 |
| \$34.15 - \$39.00 | 9,193 | 8.90 | 34.45 | 42 |

Total 560,848 5.30 \$ 18.67 \$ 11,400

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A summary of option activity under the plans is as follows:

| | Shares | Weighted Average Exercise Price |
|----------------------------------|------------|--|
| Outstanding at December 31, 2018 | 2,445,849 | \$ 30.77 |
| Granted | 1,933,920 | 41.36 |
| Exercised | (146,114) | 27.43 |
| Forfeited or Expired | (58,198) | 34.33 |
| Outstanding at March 31, 2019 | 4,175,457 | \$ 35.74 |
| Exercisable at March 31, 2019 | 683,489 | \$ 26.11 |

The total intrinsic value of options exercised during the three months ended March 31, 2019 and 2018 was \$2.1 million and \$1.6 million, respectively. The cash received from options exercised during the three months ended March 31, 2019 and 2018 was \$4.0 million and \$1.3 million, respectively. The impact of these cash receipts is included in financing activities in the accompanying Consolidated Statements of Cash Flows.

Restricted Stock - Since 2007, as part of the LTIP and since May 2016 as part of the 2016 Plan, the Compensation Committee of the Board of Directors has authorized and issued restricted stock awards to directors and key employees. Restricted stock awards granted to directors vest one-third each year. All other restricted stock awards vest at a rate of 20% per year. The fair value of restricted stock awards is based on the fair market value of AAON, Inc. common stock on the respective grant dates, reduced for the present value of dividends.

These awards are recorded at their fair value on the date of grant and compensation cost is recorded using straight-line vesting over the service period. At March 31, 2019, unrecognized compensation cost related to unvested restricted stock awards was approximately \$8.9 million, which is expected to be recognized over a weighted average period of 2.93 years.

A summary of the unvested restricted stock awards is as follows:

| | Shares | Weighted Average Grant Date Fair Value |
|-------------------------------|-----------|---|
| Unvested at December 31, 2018 | 292,450 | \$ 28.54 |
| Granted | 93,000 | 39.87 |
| Vested | (50,620) | 26.91 |
| Forfeited | (2,578) | 27.32 |
| Unvested at March 31, 2019 | 332,252 | \$ 31.97 |

A summary of share-based compensation is as follows:

| | Three months ended | |
|--|--------------------|----------------|
| | March 31, 2019 | March 31, 2018 |
| | (in thousands) | |
| Grant date fair value of awards during the period: | | |
| Options | \$19,944 | \$12,527 |
| Restricted stock | 3,708 | 2,114 |
| Total | \$23,652 | \$14,641 |
| Share-based compensation expense: | | |
| Options | \$1,225 | \$758 |
| Restricted stock | 805 | 966 |
| Total | \$2,030 | \$1,724 |
| Income tax benefit/(deficiency) related to share-based compensation: | | |
| Options | \$243 | \$301 |
| Restricted stock | 151 | 162 |
| Total | \$394 | \$463 |

14. Earnings Per Share

Basic net income per share is calculated by dividing net income by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share assumes the conversion of all potentially dilutive securities and is calculated by dividing net income by the sum of the weighted average number of shares of common stock outstanding plus all potentially dilutive securities. Dilutive common shares consist primarily of stock options and restricted stock awards.

The following table sets forth the computation of basic and diluted earnings per share:

| | Three months ended | |
|---|---|----------------|
| | March 31, 2019 | March 31, 2018 |
| | (in thousands, except share and per share data) | |
| Numerator: | | |
| Net income | \$10,902 | \$4,260 |
| Denominator: | | |
| Basic weighted average shares | 51,992,150 | 50,433,902 |
| Effect of dilutive stock options and restricted stock | 377,510 | 476,321 |
| Diluted weighted average shares | 52,369,660 | 50,910,223 |
| Earnings per share: | | |
| Basic | \$0.21 | \$0.08 |
| Diluted | \$0.21 | \$0.08 |
| Anti-dilutive shares: | | |
| Shares | 1,927,727 | 1,676,773 |

15. Stockholders' Equity

Stock Repurchase - The Board has authorized three stock repurchase programs for the Company. All other repurchases from directors or employees are contingent upon Board approval. All repurchases are done at current market prices.

The Company may purchase shares on the open market from time to time, up to a total of 5.7 million shares. The Board must authorize the timing and amount of these purchases. In May 2018, the Board authorized up to \$15.0 million in open market repurchases and on May 18, 2018, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement expired on March 1, 2019. In February 2019, the Board authorized up to \$20.0 million in open market repurchases and on March 5, 2019, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement will expire on March 4, 2020.

The Company also has a stock repurchase arrangement by which employee-participants in our 401(k) savings and investment plan are entitled to have shares in AAON, Inc. stock in their accounts sold to the Company. The maximum number of shares to be repurchased is contingent upon the number of shares sold by employee-participants.

Lastly, the Company repurchases shares of AAON, Inc. stock from certain of its directors and employees for payment of statutory tax withholdings on stock transactions.

Our repurchase activity is as follows:

| Program | Three months ended March 31, 2019 | | | 2018 | | |
|-------------------------|---|---------------|-----------------|---------|-------------|-----------------|
| | Shares | Total \$ | \$ per share | Shares | Total \$ | \$ per share |
| Open market | 5,799 | \$199,841 | \$34.46 | — | \$— | \$— |
| 401(k) | 107,000 | 4,282,961 | 40.03 | 118,203 | 4,378,925 | 37.05 |
| Directors and employees | 15,705 | 588,053 | 37.44 | 15,492 | 559,688 | 36.13 |
| Total | 128,504 | \$5,070,855 | \$39.46 | 133,695 | \$4,938,613 | \$36.94 |
| Inception to date | | | | | | |
| Program | Shares | Total \$ | \$ per share | | | |
| Open market | 4,101,566 | \$69,805,654 | \$17.02 | | | |
| 401(k) | 7,154,776 | 104,824,208 | 14.65 | | | |
| Directors and employees | 1,968,966 | 18,962,711 | 9.63 | | | |
| Total | 13,225,308 | \$193,592,573 | \$14.64 | | | |

Subsequent to March 31, 2019 and through April 30, 2019, the Company repurchased 61,992 shares for \$2.9 million from our 401(k) savings and investment plan.

Dividends - At the discretion of the Board, we pay semi-annual cash dividends. Board approval is required to determine the date of declaration and amount for each semi-annual dividend payment.

Our recent dividends are as follows:

| Declaration Date | Record Date | Payment Date | Dividend per Share |
|------------------|--------------|--------------|--------------------|
| May 18, 2018 | June 8, 2018 | July 6, 2018 | \$0.16 |

November 8, 2018 November 29, 2018 December 20, 2018 \$0.16

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16. Commitments and Contingencies

We are subject to various claims and legal actions that arise in the ordinary course of business. We closely monitor these claims and legal actions and frequently consult with our legal counsel to determine whether they may, when resolved, have a material adverse effect on our financial position, results of operations or cash flows and we accrue and/or disclose loss contingencies as appropriate. We have concluded that the likelihood is remote that the ultimate resolution of any pending litigation or claims will be material or have a material adverse effect on the Company's business, financial position, results of operations and/or cash flows.

We are occasionally party to short-term, cancellable and occasionally non-cancellable, fixed price contracts with major suppliers for the purchase of raw material and component parts. We expect to receive delivery of raw materials for use in our manufacturing operations. These contracts are not accounted for as derivative instruments because they meet the normal purchase and normal sales exemption. At March 31, 2019, we had one material contractual purchase obligation for approximately \$1.7 million that expires in December 2019.

17. Related Parties

The Company purchases some supplies from an entity controlled by the Company's CEO. The Company sometimes makes sales to the CEO for parts. Additionally, the Company sells units to an entity owned by a member of the President's immediate family. This entity is also one of the Company's Representatives and as such, the Company makes payments to the entity for third party products. All related party transactions are made on standard Company terms.

The following is a summary of transactions and balance with affiliates:

| | | |
|------------------------|--------------------|----------------|
| | Three months ended | |
| | March 31, 2019 | March 31, 2018 |
| | (in thousands) | |
| Sales to affiliates | \$ 50 | \$ 145 |
| Payments to affiliates | 127 | 10 |
| | December 31, 2019 | |
| | 2018 | |
| | (in thousands) | |
| Due from affiliates | \$ 1 | \$ 79 |
| Due to affiliates | 3 | — |

18. Segments

The following table summarizes certain financial data related to our segments. Transactions between segments are recorded based on prices negotiated between the segments. Sales of units represents the selling price of our units plus freight and other miscellaneous charges less any returns and allowances. Parts include sales of purchased and fabricated parts including our coils along with the related freight and less any returns and allowances. The "Other" category in the table below includes certain sales cost and expenses that are not allocated to the reportable segments.

Asset information by segment is not easily identifiable or reviewed by the chief operating decision maker. As such, this information is not included below.

| | Three Months Ended March 31, 2019 2018 (in thousands) | |
|-----------------------|--|----------|
| Sales | | |
| Units | 107,068 | 92,975 |
| Parts - External | 6,911 | 6,287 |
| Parts - Inter-segment | 7,922 | 7,284 |
| Other | (157) | (180) |
| Eliminations | (7,922) | (7,284) |
| Net sales | 113,822 | 99,082 |
| Gross Profit | | |
| Units | 26,543 | 16,540 |
| Parts - External | 3,684 | 3,029 |
| Parts - Inter-segment | 677 | 795 |
| Other | (4,434) | (4,179) |
| Eliminations | (677) | (795) |
| Net gross profit | 25,793 | 15,390 |

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

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our consolidated financial statements and the notes thereto, which are included in this report, and our audited consolidated financial statements and the notes thereto, which are included in our Annual Report on Form 10-K for the fiscal year ended December 31, 2018. This discussion contains or incorporates by reference “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements are not historical facts, but rather are based on expectations, estimates, assumptions and projections about our industry, business and future financial results, based on information available at the time this report is filed with the SEC or, with respect to any document incorporated by reference, available at the time that such document was prepared. Our actual results could differ materially from the results contemplated by these forward-looking statements due to a number of factors, including those identified in the section entitled “Forward-Looking Statements” in this Item 2 of this Quarterly Report on Form 10-Q and in the section entitled “Risk Factors” in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2018. We do not assume any obligation to update or revise any forward-looking statements to reflect changed assumptions, the occurrence of anticipated or unanticipated events, new information or circumstances or otherwise, except as required by law.

Overview

We engineer, manufacture and market air conditioning and heating equipment consisting of standard, semi-custom and custom rooftop units, chillers, packaged outdoor mechanical rooms, air handling units, makeup air units, energy recovery units, condensing units, geothermal/water-source heat pumps, coils and controls. These products are

marketed and sold to retail, manufacturing, educational, lodging, supermarket, medical and other commercial industries. We market our products to all 50 states in the United States and all provinces in Canada. Foreign sales were approximately \$4.2 million of our total net sales for the three months just ended and \$4.1 million of our sales during the same period of 2018.

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Our business can be affected by a number of economic factors, including the level of economic activity in the markets in which we operate. The uncertainty of the economy has negatively impacted the commercial and industrial new construction markets. A further decline in economic activity could result in a decrease in our sales volume and profitability. Sales in the commercial and industrial new construction markets correlate closely to the number of new homes and buildings that are built, which in turn is influenced by cyclical factors such as interest rates, inflation, consumer spending habits, employment rates and other macroeconomic factors over which we have no control.

We sell our products to property owners and contractors through a network of manufacturers' representatives and our internal sales force. The demand for our products is influenced by national and regional economic and demographic factors. The commercial and industrial new construction market is subject to cyclical fluctuations in that it is generally tied to housing starts, but has a lag factor of six to 18 months. Housing starts, in turn, are affected by such factors as interest rates, the state of the economy, population growth and the relative age of the population. Our sales strategy is currently balanced between new construction and replacement applications. The new construction market in 2018 and through the first quarter of 2019 has been robust, but showing signs of uncertainty. Thus, we continue to emphasize promotion of the benefits of AAON equipment to property owners in the replacement market.

The principal components of cost of goods sold are labor, raw materials, component costs, factory overhead, freight and engineering expense. The principal high volume raw materials used in our manufacturing processes are steel, copper and aluminum, and are obtained from domestic suppliers. We also purchase from domestic manufacturers certain components, including compressors, motors and electrical controls.

The price levels of our raw materials have remained relatively consistent the past few years, but the market has become volatile and unpredictable as a result of the uncertainty related to the U.S. economy and a weakening global economy. For the three months ended March 31, 2019, the price (twelve month trailing average) for galvanized steel, stainless steel and aluminum increased by approximately 15.6%, 9.0% and 4.6% (copper decreased by 1.1%), respectively, as compared to the three months ended March 31, 2018.

We attempt to limit the impact of price fluctuations on these materials by entering into cancellable and non-cancellable fixed price contracts with our major suppliers for periods of six to 18 months. We expect to receive delivery of raw materials from our fixed price contracts for use in our manufacturing operations.

We continued construction of our three-story 134,000 square foot laboratory building with ten testing cells contained within it. This unique laboratory will have capabilities beyond anything known to exist in the world and will elevate AAON's research and design capabilities accordingly. Completion of this lab in 2019 will be a significant event.

The following are recent highlights and items that impacted our results of operations, cash flows and financial condition:

- We saw significant improvement in our gross margin during the first quarter.
- Overall units sold increased approximately 16.4% for the three months ended as compared to the same period last year.
- Our warranty expense has stabilized and we expect to see continued improvement in this area.
- We invested \$8.8 million in capital expenditures, continuing our work on projects such as our new research and development lab, water-source heat pump production line, as well as other internal development projects.
- Our order intake level continued to support our high backlog.

Backlog

The following table shows our historical backlog levels:

3/31/2019 12/31/2018 3/31/2018
(in thousands)
\$166,558 \$ 151,767 \$ 74,068

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Results of Operations

Three Months Ended March 31, 2019 vs. Three Months Ended March 31, 2018

Units Sold

| | Three Months Ended March 31, 2019 2018 | |
|--------------------------|--|-------|
| Rooftop Units | 3,762 | 3,468 |
| Condensing Units | 394 | 411 |
| Air Handlers | 580 | 536 |
| Outdoor Mechanical Rooms | 11 | 14 |
| Water Source Heat Pumps | 2,289 | 1,614 |
| Total Units | 7,036 | 6,043 |

Net Sales

| | Three Months Ended March 31, | | | |
|-------------|------------------------------------|----------|----------|-------------|
| | 2019 | 2018 | Change | % Change |
| | (in thousands, except unit data) | | | |
| Net sales | \$113,822 | \$99,082 | \$14,740 | 14.9 % |
| Total units | 7,036 | 6,043 | 993 | 16.4 % |

Most of the increase in revenues is due to our price increases from 2018 with our unit sales increasing \$14.1 million.

Cost of Sales

| | Three Months Ended March 31, | | Percent of Sales | |
|---------------|------------------------------------|----------|---------------------|-------|
| | 2019 | 2018 | 2019 | 2018 |
| | (in thousands) | | | |
| Cost of sales | \$88,029 | \$83,692 | 77.3% | 84.5% |
| Gross profit | 25,793 | 15,390 | 22.7% | 15.5% |

The principal components of cost of sales are labor, raw materials, component costs, factory overhead, freight out and engineering expense. The principal high volume raw materials used in our manufacturing processes are steel, copper and aluminum, which are obtained from domestic suppliers. The Company saw improvement in its gross profit in the first quarter in 2019 compared to the previous first quarter in 2018. Material cost as a percent of sales is down for the first quarter 2019 due to stocking of raw materials at a lower cost point in 2018 and less scrap. Overhead as a percent of sales is also down for the first quarter of 2019 as the Company continues to monitor its headcount and try to increase efficiencies.

Twelve-month average raw material cost per pound as of March 31:

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| | 2019 | 2018 | % Change |
|------------------|--------|--------|-------------|
| Copper | \$3.73 | \$3.77 | (1.1)% |
| Galvanized Steel | \$0.52 | \$0.45 | 15.6 % |
| Stainless Steel | \$1.33 | \$1.22 | 9.0 % |
| Aluminum | \$1.82 | \$1.74 | 4.6 % |

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Selling, General and Administrative Expenses

| | Three Months | | Percent of | | |
|---------------------|----------------|----------|------------|-------|---|
| | Ended | | Sales | | |
| | March 31, | | 2019 | 2018 | |
| | 2019 | 2018 | 2019 | 2018 | |
| | (in thousands) | | | | |
| Warranty | \$1,109 | \$1,524 | 1.0% | 1.5% | % |
| Profit Sharing | 1,644 | 622 | 1.4% | 0.6% | % |
| Salaries & Benefits | 3,535 | 3,276 | 3.1% | 3.3% | % |
| Stock Compensation | 1,132 | 997 | 1.0% | 1.0% | % |
| Advertising | 220 | 222 | 0.2% | 0.2% | % |
| Depreciation | 311 | 218 | 0.3% | 0.2% | % |
| Insurance | 159 | 358 | 0.1% | 0.4% | % |
| Professional Fees | 730 | 782 | 0.6% | 0.8% | % |
| Donations | 115 | 498 | 0.1% | 0.5% | % |
| Bad Debt Expense | 115 | (11) | 0.1% | — | % |
| Other | 1,931 | 1,733 | 1.7% | 1.7% | % |
| Total SG&A | \$11,001 | \$10,219 | 9.7% | 10.3% | % |

The Company experienced a decrease in warranty claims paid of 9% in the first quarter of 2019 as compared to 2018. Our profit sharing expenses were up due to higher earnings.

Income Taxes

| | Three | | Effective Tax | |
|----------------------|----------------|-------|---------------|-------|
| | Months | | Rate | |
| | Ended | | 2019 | 2018 |
| | 2019 | 2018 | 2019 | 2018 |
| | (in thousands) | | | |
| Income tax provision | \$3,589 | \$980 | 24.8% | 18.7% |

The Company's estimated annual 2019 effective tax rate, excluding discrete events, is expected to be approximately 27%. The Company had a larger excess tax benefit related to our stock awards in the first quarter of 2018 compared to 2019 that caused the effective rate for that quarter to be lower than expected.

Liquidity and Capital Resources

Our working capital and capital expenditure requirements are generally met through net cash provided by operations and the occasional use of our revolving credit facility.

Our cash increased \$5.1 million from December 31, 2018 to March 31, 2019 and totaled \$7.1 million at March 31, 2019.

Under the line of credit with Bank of Oklahoma, there was one standby letter of credit of \$1.3 million as of March 31, 2019. At March 31, 2019, we have \$28.7 million of borrowings available under the revolving credit facility. No fees are associated with the unused portion of the committed amount.

We had no outstanding balance under the revolving credit facility at March 31, 2019 and December 31, 2018. Interest on borrowings is payable monthly at LIBOR plus 2.0%. The termination date of the revolving credit facility is July 26, 2021.

At March 31, 2019, we were in compliance with all of the covenants under the revolving credit facility. We are obligated to comply with certain financial covenants under the revolving credit facility. These covenants require that we meet certain parameters related to our tangible net worth and total liabilities to tangible net worth ratio. At March 31, 2019, our tangible net worth was \$259.4 million, which meets the requirement of being at or above \$175.0 million. Our total liabilities to tangible net worth ratio was 0.2 to 1.0 which meets the requirement of not being above 2 to 1.

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Authorizations - The Board has authorized three stock repurchase programs for the Company. Any other repurchases from directors or employees are contingent upon Board approval. All repurchases are done at current market prices.

The Company may purchase shares on the open market from time to time, up to a total of 5.7 million shares. The Board must authorize the timing and amount of these purchases. In May 2018, the Board authorized up to \$15.0 million in open market repurchases and on May 18, 2018, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement expired on March 1, 2019. In February 2019, the Board authorized up to \$20.0 million in open market repurchases and on March 5, 2019, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement will expire on March 4, 2020.

The Company also has a stock repurchase arrangement by which employee-participants in our 401(k) savings and investment plan are entitled to have shares in AAON, Inc. stock in their accounts sold to the Company. The maximum number of shares to be repurchased is contingent upon the number of shares sold by employee-participants.

Lastly, the Company repurchases shares of AAON, Inc. stock from certain of its directors and employees for payment of statutory tax withholdings on stock transactions.

Repurchase Activity

| Program | Three months ended | | | | | |
|-------------------------|--------------------|---------------|--------------|---------|-------------|--------------|
| | March 31, 2019 | | | 2018 | | |
| | Shares | Total \$ | \$ per share | Shares | Total \$ | \$ per share |
| Open market | 5,799 | \$199,841 | \$34.46 | — | \$— | \$— |
| 401(k) | 107,000 | 4,282,961 | 40.03 | 118,203 | 4,378,925 | 37.05 |
| Directors and employees | 15,705 | 588,053 | 37.44 | 15,492 | 559,688 | 36.13 |
| Total | 128,504 | \$5,070,855 | \$39.46 | 133,695 | \$4,938,613 | \$36.94 |
| Program | Inception to date | | | | | |
| | Shares | Total \$ | \$ per share | | | |
| Open market | 4,101,566 | \$69,805,654 | \$17.02 | | | |
| 401(k) | 7,154,776 | 104,824,208 | 14.65 | | | |
| Directors and employees | 1,968,966 | 18,962,711 | 9.63 | | | |
| Total | 13,225,308 | \$193,592,573 | \$14.64 | | | |

Dividends - At the discretion of the Board, we pay semi-annual cash dividends. Board approval is required to determine the date of declaration and amount for each semi-annual dividend payment.

Our recent dividends are as follows:

| Declaration Date | Record Date | Payment Date | Dividend per Share |
|------------------|-------------------|-------------------|--------------------|
| May 18, 2018 | June 8, 2018 | July 6, 2018 | \$0.16 |
| November 8, 2018 | November 29, 2018 | December 20, 2018 | \$0.16 |

Based on historical performance and current expectations, we believe our cash and cash equivalents balance, the projected cash flows generated from our operations, our existing committed revolving credit facility (or comparable financing) and our expected ability to access capital markets will satisfy our working capital needs, capital

expenditures and other liquidity requirements associated with our operations in 2019 and the foreseeable future.

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Statement of Cash Flows

The following table reflects the major categories of cash flows for the three months ended March 31, 2019 and 2018. For additional details, see the consolidated financial statements.

| | Three Months Ended March 31, 2019 2018 (in thousands) | |
|--|--|------------|
| Operating Activities | | |
| Net Income | \$10,902 | \$4,260 |
| Income statement adjustments, net | 10,565 | 6,373 |
| Changes in assets and liabilities: | | |
| Accounts receivable | (4,725) | (2,897) |
| Income taxes | 1,348 | (5,673) |
| Inventories | 2,678 | 3,447 |
| Prepaid expenses and other | (561) | (712) |
| Accounts payable | (5,730) | 9,833 |
| Deferred revenue | 25 | 37 |
| Accrued liabilities & donations | 411 | (3,924) |
| Net cash provided by operating activities | 14,913 | 10,744 |
| Investing Activities | | |
| Capital expenditures | (8,772) | (8,451) |
| Cash paid in business combination | — | (6,000) |
| Purchases of investments | — | (11,815) |
| Maturities of investments and proceeds from called investments | — | 5,825 |
| Other | 69 | 20 |
| Net cash used in investing activities | (8,703) | (20,421) |
| Financing Activities | | |
| Stock options exercised | 4,010 | 1,340 |
| Repurchase of stock | (4,483) | (4,379) |
| Employee taxes paid by withholding shares | (588) | (568) |
| Net cash used in financing activities | \$(1,061) | \$(3,607) |

Cash Flows Provided by Operating Activities

Cash outflows from accounts payable increased as the Company shortened its payment cycle to pay invoices more quickly.

Cash Flows Used in Investing Activities

The capital expenditure program for 2019 is estimated to be approximately \$40.0 million. The capital expenditures for 2019 relate to the completion of our R&D lab and water-source heat pump lines, along with expansion of our Tulsa facility. Many of these projects are subject to review and cancellation at the discretion of our CEO and Board of Directors without incurring substantial charges.

The Company invested excess cash flows in 2018 in investments along with completing a strategic business combination that allowed us to quickly develop our own electronic controllers for air distribution systems.

Cash Flows Used in Financing Activities

Stock options exercised increased due to the timing of employee exercises and increases in our stock price.

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Off-Balance Sheet Arrangements

We are not party to any off-balance sheet arrangements that have or are reasonably likely to have a material current or future effect on our financial condition, changes in financial condition, revenues, expenses, results of operations, liquidity, capital expenditures or capital resources.

Contractual Obligations

We had one material contractual purchase obligation as of March 31, 2019 for approximately \$1.7 million that expires in December 2019.

Critical Accounting Policies

There have been no material changes in the Company's critical accounting policies during the three months ended March 31, 2019.

Recent Accounting Pronouncements

See Note 1 of the Notes to the Consolidated Financial Statements for a discussion of recent accounting pronouncements.

Forward-Looking Statements

This Quarterly Report on Form 10-Q includes "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "expects", "anticipates", "intends", "plans", "believes", "seeks", "estimates", "should", and variations of such words and similar expressions are intended to identify such forward-looking statements. These statements are not guarantees of future performance and involve certain risks, uncertainties and assumptions, which are difficult to predict. Therefore, actual outcomes and results may differ materially from what is expressed or forecasted in such forward-looking statements. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date on which they are made. We undertake no obligation to update publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Important factors that could cause results to differ materially from those in the forward-looking statements include (1) the timing and extent of changes in raw material and component prices, (2) the effects of fluctuations in the commercial/industrial new construction market, (3) the timing and extent of changes in interest rates, as well as other competitive factors during the year, and (4) general economic, market or business conditions.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Commodity Price Risk

We are exposed to volatility in the prices of commodities used in some of our products and we may use fixed price cancellable and non-cancellable contracts with our major suppliers for periods of six to 18 months to manage this exposure.

Item 4. Controls and Procedures.

(a) Evaluation of Disclosure Controls and Procedures

As of the end of the period covered by this Quarterly Report on Form 10-Q, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer with the oversight of the Audit Committee, regarding the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded, as of the end of the period covered by this Quarterly Report, that our disclosure controls and procedures were effective.

(c) Changes in Internal Control over Financial Reporting

There have been no changes in internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

Item 1. Legal Proceedings.

We are subject to various claims and legal actions that arise in the ordinary course of business. We closely monitor these claims and legal actions and frequently consult with our legal counsel to determine whether they may, when resolved, have a material adverse effect on our financial position, results of operations, or cash flows and we accrue and/or disclose loss contingencies as appropriate. We have concluded that the likelihood is remote that the ultimate resolution of any pending litigation or claims will be material or have a material adverse effect on the Company's business, financial position, results of operations or cash flows.

Item 1A. Risk Factors.

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2018. The risk factors described in our Annual Report could materially adversely affect our business, financial condition or future results. There have been no material changes to the risk factors included in our 2018 Annual Report.

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

In May 2018, the Board authorized up to \$15.0 million in open market repurchases and on May 18, 2018, executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement expired on March 1, 2019. In February 2019, the Board authorized up to \$20.0 million in open market repurchases and on March 5, 2019, the Company executed a repurchase agreement in accordance with the rules and regulations of the SEC allowing the Company to repurchase shares from the open market. The agreement will expire on March 4, 2020. We have repurchased a total of approximately 4.1 million shares under the stock buyback programs for an aggregate price of \$69.8 million, or an average price of \$17.02 per share. We purchased the shares at current market prices.

On July 1, 2005, we entered into a stock repurchase arrangement by which employee-participants in our 401(k) savings and investment plan are entitled to have shares of AAON, Inc. stock in their accounts sold to the Company. The maximum number of shares to be repurchased is contingent upon the number of shares sold by employees. From inception through March 31, 2019, we repurchased approximately 7.2 million shares for an aggregate price of \$104.8 million, or an average price of \$14.65 per share. We purchased the shares at current market prices.

Periodically, the Company repurchases shares of AAON, Inc. stock from certain of its directors and employees. The number of shares to be repurchased is contingent upon Board approval. From inception through March 31, 2019, we repurchased approximately 2.0 million shares for an aggregate price of \$19.0 million, or an average price of \$9.63 per share. We purchased the shares at current market prices.

Repurchases during the first quarter of 2019 were as follows:

| Period | ISSUER PURCHASES OF EQUITY SECURITIES | | | |
|--------|--|---------------------------------|--|---|
| | (a) Total Number of Shares | (b) Average Price Paid | (c) Total Number of Shares (or | (d) Maximum Number (or Approximate Dollar |

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| | (or Units) Purchased | Per Share (or Unit) | Units) Purchased as part of Publicly Announced Plans or Programs | Value) of Shares (or Units) that may yet be Purchased under the Plans or Programs |
|---------------|----------------------------|------------------------------|--|--|
| January 2019 | 36,407 | \$ 35.44 | 36,407 | — |
| February 2019 | 52,826 | 39.95 | 52,826 | — |
| March 2019 | 39,271 | 42.97 | 39,271 | — |
| Total | 128,504 | \$ 39.46 | 128,504 | — |

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Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

Not applicable.

Item 4A. Submission of Matters to a Vote of Security Holders.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

(a) Exhibits

(i) Exhibit 31.1 Section 302 Certification of CEO

(ii) Exhibit 31.2 Section 302 Certification of CFO

(iii) Exhibit 32.1 Section 1350 Certification of CEO

(iv) Exhibit 32.2 Section 1350 Certification of CFO

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.

AAON, INC.

Dated: 5/2/2019 By: /s/ Norman H. Asbjornson

Norman H. Asbjornson

Chief Executive Officer

Dated: 5/2/2019 By: /s/ Scott M. Asbjornson

Scott M. Asbjornson

Chief Financial Officer