Transcript of
Pure Cycle Corporation (PCYO)
Q4 2020 Earnings Call
November 10, 2020

Participants

Mark Harding – President and Chief Executive Officer
Analysts

Geoffrey Scott – Scott Asset Management
Andrew Lester – Carlyle Capital
Bill Miller – Private Investor
Justin Shea – Private Investor
Bill Cunningham – Private Investor
Tucker Andersen – Above All Advisors
Greg Bennett – Morgan Stanley

Presentation

<u>Operator</u>
Greetings and welcome to the Pure Cycle Corporation Year Ended August 31st, 2020 Conference Call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. [Operator Instructions] As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Mr. Mark Harding, President and CEO. Thank you, sir. Please go ahead.

<u>Mark Harding – President and Chief Executive Officer</u>
Thank you, Donna. I'd like to welcome you all to our 2020 fiscal yearend earnings call. Some of the logistics, we do have a new deck for this call a few slide over to our website at purecyclewater.com, and then either on the front page, there's a link to it or in the Investors' section there'll be a link to the fiscal year end 8/31/2020 earnings presentation. And what I'll do, you can click on that and then walk through this with me. I'll note the transition of the slides as we work through the presentation itself.

So I'm delighted to be with you here today. We've had an extraordinary year and delighted to kind of highlight and give you a little bit of color about what we saw in the year and what we see coming up and answer any of your questions as we want to drill down into any of the specifics. So with that, we'll start.

So move to Slide 2 and try and get the lawyers out of the room. This is our Safe Harbor statement which all of you are familiar with. This presentation may contain forward-looking statements and forecasts that may differ from actual results.

Move to the next slide. For those of you who are new to Pure Cycle, welcome. Pure Cycle is a diversified land and water resource company. We are at our core, our water, wastewater provider we own water rights in a water short region. We also have very valuable land holdings and some very good and well positioned locations here in the Denver metropolitan area that we are developing a Master Plan Community on and create value for our shareholders and homeowners and businesses and customers through our utility segment.

Moving on to Slide 4, I'll talk a little bit about the water segment and some of the water infrastructure. This is a partial list of our inventory of water utility assets, most notably our water rights, we have a very large portfolio of valuable water rights, but also a growing infrastructure of assets that put those water rights into working order, delivering water and wastewater services to our customers. So this kind of illustrates some of the assets that we've developed.

We've got groundwater wells, we've got, you know, distribution pipeline, collection pipeline, both deep wells, alluvial wells, we now have 2 water reclamation facilities that treat wastewater. And then we have additional water storage so that we can meet the raw water demands for some of our industrial customers. Kind of a map showing some of those assets and proximity to some of our service area of the Lowry Range, this is about 24,000 acres as well as our Sky Ranch service area.

Let me draw your attention to Slide 5. This is one of our most recent additions to capital asset inventory, which is our Water Reclamation Facility. In coordination with developing our Sky Ranch Master Plan Community, we constructed our newest water reclamation facility, which is a state-of-the-art facility that treats 100% of our wastewater return flows from customers at Sky Ranch back to a high standard irrigation water supply for resale to our irrigation customers.

It's a state-of-the-art facility, 80% of the structure is below ground, it allows us to have a very low profile in a very residential community. This is what we call a zero-discharge facility. So all 100% of the water that's treated at this facility will be brought back to one of our reservoirs and will be reused either in our irrigation system or for our industrial customers. You know, it's a magnificent plant we have, you know, all the aesthetic to it, a green roof that covers the main plant that really kind of give you a look and feel of really just a tremendous asset for us.

Construction was completed in about a 16-month period and really it was a phenomenal achievement for us and for our team, because we were constructing this at the same time, we were breaking ground on a lot of the lots that we have on the Phase 1 filing one for Sky Ranch. So it was a tremendous coordination effort for our team and for our contractors teams to not only get it delivered, but on time and in budget. So we're very proud of that facility, if y'all have a chance to come visit us, I'd love to give you a tour of it.

I mean, move to the next slide, Slide 6, really talk a little bit about some of our land assets. We have about 930 acres in one of the most attractive development markets in the Denver Metro area. And in fact, probably one of the more attractive markets in the country along the I-70 corridor. We have zoning for somewhere between 3,200 and 3,400 residential units, we have about 2 million square feet of commercial zoning, which will accommodate retail and commercial uses right along the interchange.

It’s an excellent location just directly south of DIA, right along one of Denver’s largest transportation networks along Interstate-70. So it’s a very convenient location to get to, get from and get around to. So ideally, this has been really part of our great successes that most of the investments in the Denver metropolitan area are coordinated in the I-70 Corridor.

Moving to the next slide, Slide 7, we’ve been under construction for our first phase. So you see that in Neighborhood B, for the past 18 months, and now we have that complete, we’re moving on to our second phase, which will look like what you see kind of in that Neighborhood A and Neighborhood D. So we’ve got a major thoroughfare Sixth Avenue, which is the section line arterial transportation corridor that will bisect the next phase of that.

And then in addition to the residential development that we have here, we have sort of an eye out for our retail and commercial opportunities as we continue to grow in our homes. And the density that we have out in this project, we will have an ever-increasing interest in the commercial and retail corridor there. So we’ve got a significant amount of land set aside for that that’s a high value development opportunity for us. So we’re looking forward to feathering that in with our residential development.

Moving on to the next slide, Slide 8. So as I mentioned, we believe we have one of the best locations in all of Denver, most of the press that continues to reinforce not only that the I-70 corridor is a great location, but also Denver is one of the best housing markets in the country. So we see continued headlines about the activity in the Denver market, some of the drivers in the Denver market. You know, the only thing I’d like to add to that is that, we can improve our football team and see if we can find a way to get better press on that.

Moving to the next slide, Slide 9, this will kind of be a time lapse view of what’s occurred over the last 18 months really beginning with Q1, where we were just coming out of the ground, we had about 40 residents, maybe 60 homes under construction and then moving through Q2, you can see bit more activity, Q3 a bit more activity, and then ultimately kind of where we sat at year end, which was about 214 residents.

You know, this was really a testament to our team’s development of the project, but also our homebuilder partners, and then bringing value, bringing the Sky Ranch into the Denver Metropolitan market. And really the success that the communities had is in large part due to the successful partnership that we have with our homebuilders.

Moving on to Slide 10, where we sit today, we have delivered all our first phase lots. So all 506 lots have been delivered about 18 months ahead of schedule that was pulled forward by our builders really exceeding their projections for the number of units that they would be able to sell on a monthly basis, and it was delivered on budget. So you know, while typically when you accelerate schedules, you’ve got premiums for contractors to be able to deliver that.

And really, I think that we minimize the change orders and really optimize the opportunity to take advantage of either a weather or the availability of equipment while it was on site so that they didn’t have to mob and demob over the various sub phases that we had when we were delivering all of these lots. Nearly half the homes are built and sold. So we've got a little over – probably 220 homes out there that are occupied residents.

Our homebuilders are building an average of about nine homes per month. And they've modeled that out at about half that absorption rate. So I think they're thrilled, we're thrilled, we're seeing a very – a much faster absorption in that which benefits us in a number of ways notwithstanding just more lots out there, but it also increases the FX value out there, the amount of tax revenues that are available for our reimbursable that we'll talk a little bit later about and then just moving into second phase.

So we go to the next slide, talk about that second phase. It's almost twice the size of our first phase with about 50% more land. So we got a little bit more density coming into this phase. We've got the same type of product out there, where we have our standard, detached 40-foot, 50-foot, 45-foot, 50 foot lots that we have predominantly in the first filing. But we also have a lot of other product offerings. So we're going to have a much more diverse mix of product categories, we'll have some duplex categories, we'll have some attached models, we'll have some townhome models, we'll have some alley load models, in addition to all the other offerings that we have.

And what that does is really, it allows a variety of price points for the builders to try and attract a bit more of those customers out and increases again, when we have higher density on that. And it increases the number of water connections that we have, which is important to our utility segment, increases our assessed value, which is important to our reimbursables. And it provides a greater flexibility in the timing of how we and the municipal authority that we work with the Sky Ranch Community Authority Board, look at the timing of bond issuances for recovery of those public improvement costs.

Moving on to Slide 12, talk about timing for our next phase. You know, we've got all these varying product classes and new builders coming into this. So we have one of our carryover builders will be in the second phase, but three new builders in that and we hope to break ground yet this year with some grading activity and our erosion control installation sometime later this month or the first part of December.

One other he things we like to do here at Colorado is, we like seasonal work. We like the earth work in the winter, because that has the flexibility that we can continue to work regardless of what the weather is outside, have some model home lots available sometime early fall in that September timeframe and then continuing to have production lots available by winter. So the builders can come in and they can they can get their model home lots up and available for what's their heavy sale season, which is right after the Super Bowl. So we'll have a high expectation that while we won't be in the Super Bowl, maybe next year Super Bowl.

Let's take a look at our scorecard. So move on to Slide 13, filing one cost, if you take a look at our costs, we had about $35.8 million that we had budgeted for that. We came in at that 30 we're probably came in at right around 34.8, 34.9. So we still have about $900,000 that we have reserved for warranty items and contingency items on punch out items that we have in the remaining portion of that.

And then if you take a look at what we earn on that we've earned close to $80 million from that investment. So that came in the form of around $36 million, $37 million in lost sale revenues, we've got a portion of the reimbursable is $10.5 million, which is the first phase of those reimbursables together with another $18.5 million that's yet to be reimbursed to us. So that continues to accrue, we've got time value of money component on that.

So we do get paid for that time component as the assessed value of the community continues to build up and we have more opportunities to bond more of that public infrastructure. And then the water, wastewater tap fee revenues going to be coming in right around that $14 million mark. So it's a terrific opportunity for us, we've been very successful on that. We're very proud of it. As you can see from the time lapse photography, and we'll keep uploading some of those images on our website as well to give you guys a kind of a bird's eye view of what the community, how the community continues to grow.

So from that, we're going to carry that one forward into the second filing. So that'll be right around 900 lots. We've got a bit of an improvement in our pricing for that. So you know we did have to kind of attract the builders to the market and define ourselves in the first phase of this. But I think we still have some very good margins in our second phase or even much better margins in our second phase than we had the first phase. We're projecting costing in about that $65 million range. So what revenues to be around $72 million, $73 million.

And then when you take a look at all the public improvements that will be investing into that, that are reimbursable another $48 million, and then again, another $21 million, $22 million in tap fee revenue. So when you take a look at the next 900 lots, while the first phase generated about $80 million for us in revenue. The second phase is going to look to be about $140 million, $145 million in revenue.

Next slide I want to kind of really give you a little bit a look fee is that, what the rest of the story would look like? So filing one showed how profitable you know, the combination of this land and utility model was, you know, we developed these assets. And so as we build that infrastructure, we add to the asset base of what the company is doing, as well as the free cash flows for that. So the first 506 slots really generated that $80 million, the next 900 lots is about that $145 million revenue. And then you take a look at the rest of Sky Ranch. And so we've got a pretty conservative view here that would generate about another $360 million.

And what we did there is really kind of project out the commercial on the same equivalency as a residential, which I can say is going to be conservative by maybe a couple of orders of magnitude. But it gave us the ability to kind of cast that out in terms of how we look at the water service connections. So we look at it in terms of being able to deliver 5,000 connections, while we sell the commercial lot on a price per square foot as opposed to a standard residential lot. We took a look at kind of projecting out that margin the same way.

So if you look at this, cumulatively, Sky Ranch is a tremendous asset for all of us. You know, it generates almost $600 million of revenue for us and just a great opportunity, you know, hundreds of millions of dollars in margin for us and really defines not only our entrance into the land development segment, but also creates perpetual customers recurring customers for us.

So let's move to the next slide, slide 15 really talk a little bit more about our water and wastewater utility segment and how that combines with the land development segment. Our land assets are huge revenue driver for shareholder value, but the utility segment creates those recurring utility customers or perpetual customers. So that's something that, you know, we really have kind of the best of both worlds, we get a large asset value from the Master Plan Community, and then the customers that move in there are our customers for life.

Moving on to slide 16, kind of the growth in our water utility assets, we've seen 64% growth in our investment in water utilities over the past four years. And these are long lived assets, these assets will deliver water and wastewater services to our customer at high margin opportunities for us, I mean, they're fairly priced. And really, these customers last for, you know, hundreds of years, as long as the houses are going to be out there. And so we're delighted to continue to grow our water assets. And, you know, we get the water and wastewater tap fees in addition to the monthly water and wastewater revenues.

Moving on to kind of the next slide, Slide 17, as we continue to grow the recurring revenue, customers from what was you know, maybe a couple of hundred customers three years ago, we're over at about 650 and be moving up to 5,000 customers or slightly more than 5,000, probably close to 5,500, 5700 just from the Sky Ranch alone.

And so, you know, it's creating tremendous value for us on that recurring revenue, our water portfolio is, as those of you have been following us through the years is, is very large, this is only a fraction of what we can serve, we can serve up to about 60,000 connections. So we continue to look to expand through both land acquisitions and water utility acquisitions that both can you know, leverage ourselves in the successes that we have on Master Plan Communities as well as continued to grow the success of our utilities.

Moving on to Slide 18, you know, 2020 has been a year. From Pure Cycle's perspective, you know, if you just look at the analytics, it's another record year of revenue growth, asset growth and cash liquidity growth, you know, 2020 will be a memorable year in many ways and many of them are not so good memories, but for our company, you know, I can't emphasize enough how great our team has executed on expanding all metrics to our business, maintaining, you know, a pristine debt-free balance sheet in one of the most challenging economic environments is really has been a testament to kind of how our team views you know, working for us and the work that we do and the customers that we serve, so terrific, kudos to them for their continued focus on maintaining their professionalism in a very difficult and challenging year.

Moving on to the balance sheet. This is you know, the view of our clean liquid debt-free balance sheet and I'll let you guys study that at your leisure. Income statement, another marvelous high margin income statement with continued growth in earnings per share. Those of you who have followed us through the years probably appreciate how hawkish our position is on our share count. You know, our last equity raise was more than 10 years ago. So, you know, both management as well as our Board are very hawkish on maintaining shareholder value and being able to grow organically as well as through acquisitions.

Moving on to the next slide, talk a little bit about you know, it is noteworthy to talk about our continued succession planning and adding additional C-suite talent. We have a new CFO who's on the call with me, Kevin McNeill. Not that the other guy that was doing that for the past 20 years was all that bad, but Kevin is bringing in tremendous value to us.

And so I really do appreciate all of the advanced support that he's bringing in the C-suite level, and then our extremely talented board. And we continue to bring our new board members with highly valuable experience and it really does give a company of our size, tremendous horsepower. And I can't say enough about those folks and the stewardship and the guidance that they give both Kevin and I and our senior management team here to be able to make the – achievements that we've made through the years.

Moving on to the next slide, take a look at some of more specific financial metrics, really growth in all key areas, growth in revenues, growth in our margins, growth in our net income, our EBITDA, cash, assets, shareholder equity, you know, all metrics of this year-over-year, you know, we continue to grow those, we continue to grow those margins, we continue to be efficient about it, we continue to keep our eye on execution and creating shareholder value. So those are the key takeaways from this year is really just demonstration of execution demonstration of really, what has been a long accumulation of these very valuable assets.

Move on to the next slide, if I were to say one of the frustrating things is our share price. While I'm sure you've never listened to a CEO didn't note that their share price was lower than what the value of the firm should be represented. And you know, there's probably a lot of things out there that would comment on that, I'll just leave that as, you know, a great opportunity for those of you listening and those of you who are new to take advantage of sort of a company that's probably under recognized and certainly under appreciated.

So with that, I'm going to turn it back over to the moderator and kind of open it up to some questions and see if I can drill down on to some of the specifics that you guys might have on how we've done this year. Donna, I'll send it over to you.

Operator
Ladies and gentlemen, the floor is now open for questions. [Operator Instructions] Our first question is coming from Geoffrey Scott of Scott Asset Management. Please go ahead.

Q: Good afternoon, Mark. How are you?

Mark Harding – President and Chief Executive Officer
I'm great. Geoff, how are you?

Q: Good. You continue to exceed our expectations. Timing on the commercial. You know, the last time I drove by there was a lot of activity. How close are we to getting you know, really a commercial push on this?

Mark Harding – President and Chief Executive Officer

You know, what we're trying to do, I have a lot of people that are sending us offers and we're being very selective about it, because a lot of this is people that want to buy it. And then they want to hold it for a period of time. And then they want to develop it for another user. And I'd like to eliminate the middleman in that, quite frankly, I'd like to go directly to those users.

So we're, you know, we've got a new board member, Jeff Sheets, who brings a tremendous amount of commercial experience. He's been doing it in the Denver market in very valuable spots. And, you know, he understands the model about what the grocer needs to see, what Kroger needs to see, what Home Depot needs to see, what Walmart needs to see, what the fast casuals and all of those and really taking a look at you know, we have a very strong balance sheet.

We want to really optimize some of that structure going directly to them. And while that traffic is getting there, it's not quite there, I would say, you know, as we start breaking ground on the second phase and we've got not just the three builders who were punching out their remaining lots on the first phase, and then four builders on the second phase, there's going to be a tremendous amount of traffic out there, that's going to answer some of those questions. So I would put that not in a '21 timeframe, but probably a '22 timeframe, so we can really optimize some of the value of it.

Q: Okay. Can you kind of take us through the discussions with the builders only, one of the three renewed? And you have some new ones? What were the dynamics of those discussions? Did it have to do with price or customer acceptance? Or, you know, just take me to the discussions?

Mark Harding – President and Chief Executive Officer

Sure. So with one particular builder, they had acquired another builder. And so just as we were starting to solicit interest and specific contracts for them, they were on a freeze, just because they had to choke down an elephant of an acquisition, and they couldn't get to the timing of it, you know, wasn't that they were dissatisfied, it was just that, they said, listen, I definitely want to be in, but I cannot do anything for another formats.

Then I said, you know, listen, I can't hold your slot for that period of time and they understood it. And you know, they were my first bridesmaid. They said, okay, we're back, you know, did anybody fall off? And certainly, if they did, let me know. The other player, it was a price deal, you know, they got such a good deal in the first filing. And when I increased it 40% of them, they were sort of choking on and gone, oh, my god, you got to be kidding me.

And I said, you know, the real response should be, you know, you're welcome for having such a great opportunity in the first phase, and the second phase is a bit more averaged price. And they sort of said, Yeah, you know, and so, you know, not waiting to have that train catch up, you know, I said, listen, you know, this is the day you're either in or you're out.

And, you know, I had even getting the next four in, I still had to tell another four and they're all national builders, that, you know, I couldn't make room for them in this phase. So yeah, I mean, it was not just this four or even the three new ones, there were four or five national builders who

I still said, you know, I can't get you into this phase. But I will show you lots in the next phase. So it's been, it's that kind of thing.

Q: As I said, last time, I drove through it and it looked great. So congratulations. I'll let somebody else in.

Mark Harding – President and Chief Executive Officer
Thanks.

Operator
Thank you. Our next question is coming from Andrew Lester of Carlyle Capital. Please go ahead.

Q: Hi, thanks for taking the call. Congratulations on a really good quarter. A couple of questions. If I read one of the charts correctly, if I understood it, needed water usage seemed to be down 77%, which seemed odd, could you sort of help me understand that but something sort of interrupted, and is that something that snaps back?

And secondly, sticking with your sort of analogy with the Denver Broncos, sort of the ultimate tally is whether you know, winning or losing is the score. So it is disappointing that the share price is down. But in light of all your sort of excellent execution and significant cash balance, I wonder as to management given any thought to a buyback or any sort of type of activity to enhance shareholder value?

Mark Harding – President and Chief Executive Officer
Good question. So let me give you the first one, which is pretty straightforward. The reason that water deliveries are down is really 100% attributable to oil and gas. And the fact that, you know, the COVID issue is really just crippled oil and gas, domestic oil and gas development. So we've had, you know, we had one frac come in after year end so we did that, we had one frac coming in the first quarter, but for the most part, that's what that's attributable to, does it snap back? Yes, I think it does snap back.

You know, it's a function of the, you know, the feast or famine industry itself, but we do know that this is a very oil-rich area. What makes it work is fracing and what makes fracing work is a whole bunch of water. So that's how that goes.

On your point of, you know, points matter. And so the at the end of the day, we put up some good points here. You know, the game's not over and, you know, the share price doesn't necessarily reflect the points that are on the board and you know, at what time does the company management look to allocate resources that wouldn't otherwise be available to the company for investing into its overall operations into, you know, changing the denominator and the share count, that's certainly something we talk about often. We're moving into our second phase.

So we want to keep a little bit of powder in there for opportunities on our second phase, whether that's going to be delivering those lots to our builders, taking advantage of some of the commercial opportunities or even some acquisition opportunities. So we do have our nets out for how we can continue to deploy that capital, we think we have some pretty good talent here, we have the combination of using water and land development, where I think 2 and 2 equal more than 4. And so we want to try and save some powder for that. And then to the extent that we continue to build that asset base, Andrew, that's certainly part of the equation and part of that nexus that we'll consider.

Q: So if I can just ask one follow-up in light of your comment, when it comes to potentially considering sort of acquisition of land or other assets, which I assume is what you were alluding to in terms of deployment of available capital, could you just share for a moment, how you think about that, you know, sort of what the cost of raw land or something would have to be to you, relative to your expectations for the future? Thank you.

Mark Harding – President and Chief Executive Officer
Yep. So you know, it is either raw land or you know, continuing to grow the utility segment and diversify, where we're providing water and wastewater. And you know, sometimes we pick up customers as a part of that. So we did do that already through our Wild Pointe acquisition. We like land that does not have zoning that does not have water, so that what we're doing is bringing our water portfolio to the equation, getting zoning on it. And if we do nothing more than that, we add value to it. So there's plenty of land that is in our sandbox that have those opportunities.

You know, we recognize we did very well on the acquisition of Sky Ranch, you know, we bought it when the world was on fire in 2010. And, you know, banks couldn't get rid of their positions fast enough. You know, it doesn't have to be that, you know, while we do have, you know, a mindful eye and ROI for land acquisitions, you know, we have the ability to generate some pretty good returns here. And so they don't have to be, you know, 80%, 90% ROI.

They can be in the high teens and we can be a little more risk on, on getting some of those types of acquisitions that still are good, appropriate value, you know, the market's probably on the high side of it right now. But there's still opportunities, there's opportunities, even if I pick up a high value, you know, not high value, but I'd say, a piece of property at, you know, sort of the high end of the market that doesn't have water, it's still when I add my water to it, adding value to it. So, you know, there's a good transaction for both the seller of land and a good transaction for the company and being able to take a look at those types of acquisitions.

Q: Thank you.

Mark Harding – President and Chief Executive Officer
Yep.

Operator
Thank you. Our next question is coming from Bill Miller, a private investor. Please go ahead.

Q: Hi, Mark. Congratulations, great quarter, great year. My question is really three to five years from now. Where do you think the profile of the company is going to be? And particularly, what kind of recurring revenue as a percentage of your overall revenue where you have? Is that your goal to increase that as time goes on? Or what are you going to be more of a cyclical company where you make some deals and you know create a hell of lot of value and lot of cash?

Mark Harding – President and Chief Executive Officer
Yeah, I like the latter part of that, you know, company that creates a hell of a lot of value and cash, those are good things. And those are kind of my North Star on that. So I do want to do that. But in doing that, the nice thing about it is, we do create those recurring customers. And so, you know, three to five years, we have Phase 2 built out, I have Phase 3 coming online, I have commercial coming online, I likely have other surrounding properties coming online, and while you know, we might be adding 20, 27, 30 homes a month, you know, it would not be inconceivable for us adding 40, 50 homes a month in that timeframe.

So, you know, and adding those provides asset value, which is great returns, it allows us to have that powder to be able to reinvest into other asset acquisitions, other utilities, dividend, share buyback all of the above and then it continues to grow our recurring customer counts so that you guys get the chance to see, you know, an increasing dividend yield from that recurring revenue stream. So, you know, you've touched on kind of, you must have a microphone into our board, because we talk about those things every board meeting.

Q: Well, would you aspire to have 50:50? Or are you thinking more of 80:20 with anything the land and the development of the land?

Mark Harding – President and Chief Executive Officer
I do like the development of land, you know, and I do like those opportunities where our water adds value to the land. And you know, that I like being disciplined about that and staying within a reasonable reach of our infrastructure, which, you know, there's a lot of land in that area. And so that had become the determination of, you know, the proper pricing between the seller and the buyer.

And, you know, we have a little – you know, we can risk on and risk off, depending on the view of the market. And, you know, a lot of those acquisitions are made in, you know, times when they're more challenging for the seller, and they are out with the buyer and having liquidity and that gives us an opportunity to take advantage of that. But, you know, we also don't want to just have a big balance sheet for balance sheet purposes.

Q: Right, and when do you think you'll get involved in the commercial development line, I-70?

Mark Harding – President and Chief Executive Officer
I think that's going to start in, you know, late '21, '22 timeframe. You know, we're going to have opportunities that we can feed into that, you know, we can maybe do a finish lot on that and bring a tenant in there, as opposed to just selling raw ground. And, you know, that would be a high value, per square foot lease, which would be a recurring customer, I don't know that I want to go vertical, but I can give them you know, ground leases and things like that, that are very attractive.

Q: Great. Well it sounds very, very good. Thank you.

<u>Mark Harding – President and Chief Executive Officer</u>
Thanks, Bill.

<u>Operator</u>
Thank you. Our next question is coming from Justin Shea, a Private Investor. Please go ahead.

Q: Hi, Mark. Congrats on the great quarter. I just had two quick questions. The first one was like, you know, as we think about the company becoming more recurring revenue base in the long run, I was wondering how you think about your pricing power going forward, maybe like 5, 10 years out?

<u>Mark Harding – President and Chief Executive Officer</u>
Pricing power of the water utility or pricing power of the land?

Q: For water utilities.

<u>Mark Harding – President and Chief Executive Officer</u>
So there's two types of pricing power there. Ones in the connection charges, the tap fees, which are kind of that capital component that really monetizes the scarcity value of water, and there is pricing power there. We're a bit more disciplined about pricing power once we have a customer that has no option. So, you know, there's some constraints to that, you know, while we don't have a direct regulatory climate for adjusting our rates and charges, that's something that's significantly more scrutinized.

So I would say we have strong pricing power on connection charges, because at the end of the day, we're preferential on where we want to supply water, where we commit to supply water. And those tap fees, you know, a developer, a landowner have choice, they can either choose to go with that at those tap rates or they can, you know, choose to get their water from another source.

So there is pricing power, both from our strength, our positioning, but then also, as the scarcity value water continues to grow, I mean, the thing that brought me into this business, Justin was just a simplistic macroeconomic argument, where if you look at water, and particularly water here in Colorado, we do not have any other options. I mean, if you live on a coast, at some price, you can make more water, right.

You can desalinate, you can make more water, we do not have that option here. There's a fixed supply of water and a growing demand. And you know, drawing, you know, from my macroeconomic license, that you have a fixed supply and a growing demand, there's only one thing that happens to change that and that's price. So we think that that price will continue to grow just because of scarcity value alone.

Q: Got it, got it. That makes a lot of sense. Thank you. And then the second question I had was sort of, you know, going into the winter months, do you see absorption in the first days of Sky Ranch declining? Or do you think it'll remain strong through those months?

Mark Harding – President and Chief Executive Officer
Now, I do think it will remain strong, you know, we build 12 months of the year. You know, it's, it's a lot easier to build in the summer months, but you know, they do a lot of foundations in prepping for the winter months. So you know, what they likely do is, they just bulk up on pouring a lot of foundations in that October-November timeframe, and then they build vertical in the rest depends. So they got to catch up to the foundations that they pour in the early part of the – or the late part of the fall. And then you know, they can go vertical, and there's really no weather constraints to being able to put up the sticks on the houses and they sell 12 months of the year.

So I mean, while there's seasonality to the industry, and it really doesn't matter where you're at, there seasonality to housing across the country which oddly starts after the Super Bowl, you know, all of the homebuilders sort of say, that's the starting gun and it doesn't matter whether you're in Southern California, whether you're in Northern Massachusetts, it's the end of the Super Bowl and that's a mystery to me, but they, that's what they want, they want to have all those lots ready for that March-April timeframe and capitalize on the marketing that they're going to do in February.

Q: Got it. And then last question is, do you guys take on any leverage when you guys perform this horizontal lot development, or is it just straight from your cash balance?

Mark Harding – President and Chief Executive Officer
So we have had the luxury of being able to use our own capital, that together with how we structure our transactions with our builders. So what we do is, we let our equity ride in the land. And then we use, you know, kind of this model of a third, a third, a third pricing model on delivery of our lots. And so our homebuilders will pay us as we progress on finishing their lots.

So they'll give us a third of that cost when we get the plat, they'll give us another third of the lot cost when we finish the wet utility. And then they give us the last payment when we finish the finish lot. And so what I'm able to do is really use their money to make all the improvements and then I, you know, I get paid on the equity value of the lot in that last payment.

Q: Great. Got it, thank you. That's it for me. Appreciate it.

Mark Harding – President and Chief Executive Officer
You bet.

Operator
Thank you. Our next question is coming from Bill Cunningham, a Private Investor. Please go ahead.

Q: Hi, Mark.

Mark Harding – President and Chief Executive Officer
Hi, Bill.

Q: I actually have questions on how many acres are involved in the 895 lots that you're talking about? Each of your blocks are, I believe 160 acres and it appears that –

Mark Harding – President and Chief Executive Officer
Yeah technically not, because we got to exclude those land areas that I've got to dedicate for school sites and things like that.

Q: Well, yeah –

Mark Harding – President and Chief Executive Officer
So if you look at it –

Q: Yeah, yeah that's what I was going to say, was, yeah, it looks like Neighborhood A is totally allocated either for the homes, for the school or for the parks. But it's Neighborhood D that I'm not clear on, because there's kind of a blank area in the bottom half of that. And I'm wondering whether that's part of the 895 for future use or whether that would be in addition to the 895?

Mark Harding – President and Chief Executive Officer
That'd be in the addition to the 895. So there's a bunch of space that goes below where we're at, that will be, you know, the net, one of the subsequent phases of this, that will be, you know, hundreds of homes still left in that quarter section. So if you look at it, our first filing was about 151 acres, this is about 247, 250 acres total, so about a 50% increase in the actual acreage and about doubling the number of density that we have.

Q: Great, good. So there's a lot of extra land there.

Mark Harding – President and Chief Executive Officer
Yeah, we sell a bunch of –

Q: Also switching on the timing of revenue on this section, it appears that you're going to be delivering some lots, potentially late winter, which I assume would be revenue and income-producing activity from financial statement point of view. I remember with Phase 1 that you were receiving a lot of deposits that you couldn't record as income. So I'm wondering if that might be an issue with this next phase?

Mark Harding – President and Chief Executive Officer
So it'll look a lot like that, we will be getting, you know, a bunch of builder money. And you know, and that third, a third, a third model, we recognize revenue on that percent complete basis. So as we're constructing, you know, you'll see that revenue fall through the P&L as we complete the various components of that on a quarterly basis, so we try and time those things out.

Not to be so lumpy, but there'll be a little bit lumpy, but you know are going to – you know, you're going to see the cash position roughly stayed the same, because spending a ton of money but the cash position staying roughly the same, because we're going to get money from other builders on that and then, you know, recognize the revenue as we complete the lots on a percentage basis.

Q: Very good. Thank you, Mark.

Mark Harding – President and Chief Executive Officer
You bet. And I think I've got your email thing fixed although I did not email and for everybody, apologize, I didn't get a chance to send out the investor list email for those of you that are on our investor list, and for those of you who are not on our investor list, please email me and I'll put you on our investor list.

Operator
Our next question is coming from Tucker Andersen of Above All Advisors. Please go ahead.

Q: Hi, Mark. How are you?

Mark Harding – President and Chief Executive Officer
Tucker, great to hear from you.

Q: Yeah, I have several questions. Let's just take them one at a time, if you don't mind. Do you have any visibility on the oil and gas, both in terms of the fracing water and in terms of the royalties? Are we at a price where the wells that have been drilled are still producing? And could you talk a little bit about what you think, or you might have to get to for more drilling?

Mark Harding – President and Chief Executive Officer
So I think the wells that we have drilled in our HPP, we still get royalty revenue from that. So you know, that's still 100% margin for us, it's still, it's in the other income section. So it's below the line on that, you know, visibility, our new operator in the field is really owned by the Canadian Public Employee Pension Plan. So they operate a lot different than, say, maybe one of the publicly-traded companies, you know, they look at this thing for the long haul. And the thing that their eye is on is the encroachment of development, right.

So the position that they have is, you know, development is coming from the West to the East. And, you know, Sky Ranch is kind of the first of the on the front of that train. And they want to be in drills and out before houses encroach on that. So I would say, they're probably inclined to be a little bit more aggressive than maybe a public person would be, just because while price is important to them, you know they also want to make sure that they get those assets drilled and producing, because that could last decades.

And so, if they're a little early on that, because you know, price would necessarily be drilling at $40 a barrel, and they'd like it to be $50 a barrel, they could probably live with something like that, you know, I'll leave it to them and have them give us that guidance. You know, we're very reactive to that, rather than proactive to that, but you know, it's a very good field, I'd say the demand for oil is down, because of COVID.

And, you know, next year, you know, we're all knocking on our noggins here to make sure that we all get those vaccines and, you know, can move forward with our lives and get back to what would be normal operation. So you know, that's closer than closer to us ahead of us than it has been behind us. So those are all good metrics for us. You know, I can't dial it in any more than that. But I do see that being a significant opportunity for the company. That's a high margin opportunity for the company and we will continue to take advantage of.

Q: Yeah, the market shares your optimism, given what happened to oil prices yesterday that of the vaccine is real, but the prices are clogged, but I guess in terms of visibility, the answer is we'll know when you know.

Mark Harding – President and Chief Executive Officer
Yeah, that's right, that's right.

Q: Could you help me understand a little more? The reimbursement for the public amenities? And how that works to refer to as assessments go up more can be bonded? And then are those bonds the obligation of public authorities? Or how does that work?

Mark Harding – President and Chief Executive Officer
So, yes, they are the obligation of a public authority. And so they're based on tax revenues. And so the tax revenues are a function of a percentage of the value of the homes and the businesses that are built in that subdivision, Colorado is what we call a growth pays its own way state. So every new development has its own unique set of municipalities that fund its own infrastructure from its own houses. And so we have that, you circle that up for your own development.

One other thing typically when you take a look at Colorado development, you don't get all your reimbursables back if you have just residential development. And the reason being is, we wait our taxes to commercial properties. So we cut our – if the commercial property subsidize our residential properties, that's a better way to say it.

So, whereas I might get a 7% of the assessed value of a residential property, I get 4 times that for a commercial property, so I get 28% of the assessed value of a commercial property. And now that we have, you know, any project that has even a little bit of commercial, you know, really does improve their opportunities to get back there reimbursables and the bulk of our 160 acres gives us really were long on tax revenue for our reimbursables.

So you know we find ourselves in one of those very unique positions where those will, we expect to fully recover all of our reimbursable in this particular project. And the reimbursables really are just those public improvements, right. The roads, curbs, gutters, drainage, channels, all that add infrastructure that's ultimately turned over to another municipality, who said, you know, oh, I'll operate and maintain this, but because you're the new growth, and you're responsible for it, you have to cover that cost.

And so that cost really gets in the property taxes, both the business property taxes, as well as the residential property taxes. Adding more units creates more assessed value. So instead of me having, you know, 600 single-family detached homes that call it, $400,000, each you know, I'll have $900 at an average value of maybe $375,000. So some of them are going to be smaller, but they're going to have more, cumulatively, the higher the density, the more assessed value and the more recoverability you have out of those reimbursables.

They're a little bit lumpy and there's a little bit of art to the timing of those, you know, in the first phase, what we did was, we issued those after we had about that 4,550 units under construction, you know, wasn't – you can issue them with zero homes up or you can issue them after all your homes are built, and somewhere in there is that optimization, and we work with our financial advisors to really take a look at the market condition and you know, whatever's occurring at that time.

Sometimes there's a chase for yield and Muni bonds are a good way to they can get that yield. And so the timing of that may not be as important. So we'll continue to keep an eye on that for the timing of those bonding and those sorts of things. But they accrue until we get those bondings, you know, I think we have a 6% interest rate on that. So you know it's still accruing that time value of money component.

Q: But because of the ratio of the commercial to the residential, will it be somewhat back-end loaded, because your commercial development is back-end loaded?

Mark Harding – President and Chief Executive Officer
Well, it's probably midstream-loaded, let me put it that way. You know, I would say the commercial, you know, the commercial isn't going to be the first thing that gets developed and it's not going to be the last thing that gets developed.

Q: Second, could you guys give us a little color on where you see the Denver market in general? You're right, it has been one of the best markets in the country. Do you see any danger of overheating and overbuilding at this point?

Mark Harding – President and Chief Executive Officer
You know, the only danger is, we're going to put up a sign that says, "No Californians" no offense while you're from California. You know, we've turned out California blue state, used to be a Texas red state. So when you take a look at the driver's license conversions there, they're almost 3:1 from California now, and –

Q: Yeah that's why court cards are lost.

Mark Harding – President and Chief Executive Officer
Yeah, that is exactly. At the end of the day, we are seeing an in-migration from everywhere, frankly, you know, our greatest secret was always our weather. Somehow, we ended up making sure that it snowed on the Monday Night Football game. And I think everybody's figured out that that's not what happens the other six days of the week. So great weather, great climate, a great diversity, probably the most highest education per capita of a major metropolitan area, you know, tremendous workforce potential.

So you're seeing a lot of Silicon Valley get out of dodge and open up shop here and other places that have that high intellectual capital together with a reasonable standard of living. And I see that continuing, Tucker. I mean, to those of us who are natives, we lament on the fact that it was great when nobody else knew it. But certainly the economy is helping out, you know, bringing new opportunities for the city and new investment and new, you know, new growth.

Q: Yeah, my daughter just traded up from her condo to a single-family home. So she is committed. One comment and one final question. In terms of the previous question about stock buybacks and the stock being undervalued? My comment would be, I'm glad you're holding lots of dry powder for whatever happens.

But in the long run, the way I hope your board looks at it is just the stock buyback is another alternative investment, what the long-term returns are possible on that, which is a question of how much undervalued is and what your other opportunities are. So I would just hope that's one of the considerations the board and they do measure acquisitions against what they're doing by buying some of your own company when they buy your stock back?

Mark Harding – President and Chief Executive Officer
Sure.

Q: My final question is, you know, now that you have the expertise as a land developer, and you've done this incredible job with what might have been, you know, what the corporate lifetime opportunity of Sky Ranch? Do you – given how busy you are and given how many balls you're juggling? Do you have the bandwidth right now to really expand into another land development opportunity? And how do you think about that just about the stress on your organization?

Mark Harding – President and Chief Executive Officer
I think we do, you know, we've ramped up, we're very careful about how we right-size the organization. And so, you know, we still have, you know, we still send out to the market through a competitive bid process, a lot of the big heavy lifting out there.

And so whether, you know, we can get multiple groups doing that at the same time without diluting ourselves, you know, bringing on senior manager and bringing Kevin on, you know, we've got very strong talent in assistant controller range that we bolt up on, to allow us to make sure that we're administering, you know, multiple projects at the same time without losing control of our cost containment and those sorts of things. And then you can right-size into some of those field guides up and down, you know, they're readily available in the market.

And so, I'm pretty confident that we've got the institutional structure there. And, you know, we can capitalize on, you know, pursuing those opportunities. And as we get those opportunities, you know, adding value through sort of the high level stuff by zoning and water availability and design, which are all outsourced, you know, we don't have those skill sets in our bailiwick, and really would never, just because we want to go to the people in the market that are doing that for the land planning and the civil work and those sorts of things. So all those things are really dialed up and dialed down, depending on the workload from consultants, and you know, the teams that support us in those avenues.

Q: That's very helpful and Thanks for rewarding your patient investors.

Mark Harding – President and Chief Executive Officer
Well, thanks for being one of those.

Q: Thanks.

Operator
Thank you. Our next question is coming from Greg Bennett of Morgan Stanley. Please go ahead.

Q: Hi, thanks for taking the question. I didn't hear the beginning of the call. But have you gotten all the permits for your Phase 2? I think the last call you said you were, because of COVID, you were awaiting on things to be signed off on?

Mark Harding – President and Chief Executive Officer
Yeah, the permit-wise, all that stuff has been done for some time. That challenge is when you go through all the CDs, all the civil work, all the drainage work, you know, you know phase 1 drainage study and Phase 2 drainage study. And then that goes over to the regulatory agencies, and they've got to review it through their models and so it's the detailed engineering that has been taking longer than it should have. And I'd say, we're within, you know, maybe two, three weeks of having most of that stuff buttoned up to be getting a grading permit and start breaking ground.

Q: Okay. And the first homes from Phase 2 will not be delivered. It'll be a year from now, is that correct?

Mark Harding – President and Chief Executive Officer
Yeah, we'll squeeze that we bit more out of it than that. But you know, the bulk of them will start to be coming in about a year from now.

Q: Okay. When would you apply for Phase 3, then? How long is the process for setting up for grade? Or are we way too early for that?

Mark Harding – President and Chief Executive Officer
No, no, no, no, we would likely probably start that kind of end of next year, starting to get some of the engineering going on that and then overlapping that as we're building out, maybe, you know, the second or third sub phase of this second phase to start to bring on that online. I think you're going to see some ones and twos in the commercial layered into that as well. So those will all be going concurrently.

Q: And then as far as for a growth perspective, if we were to look at your water assets, how far north do you go and how far south? Are there markets that you can, if somebody has land and they don't want to sell it to you, but they want your water and they want water and they want to give you the utility business? You go 50 miles north or what's the, I guess what's the universe for the use of your water asset?

Mark Harding – President and Chief Executive Officer
You know, I probably classify that as a 20-mile radius around where we're at. So you kind of look at, you know, the I-70 Corridor, Sky Ranch is about 5 miles north, you know, we've got Wild Pointe, which is about 10 miles south, you know, we can go farther east, we can go a little bit farther north, west would be difficult, because then you start getting into the urbanized areas that already have water system. So when we look at those growth of the utility, customers we look at, you know, north, south and east, but not west.

Q: Okay. So I don't want to work out worse out there, you've got 10 years' worth of production probably, am I correct for selling of lots and development? But if you're – if you go 10 miles away, is that a potentially competition for your builders?

Mark Harding – President and Chief Executive Officer
I would not say so. You know, the market segregates itself out in a number of different ways. So, you know, there's a cliff for us on the west side, so we can't grow west. And everything coming out to Sky Ranch and the I-70 corridor is developed. So we are in the sweet spot. I mean, whether it's our land, the neighboring land, neighbor – neighboring land north of us, neighboring land south of us or, you know, lands eating through our Sky Ranch project continuing east, that's the only way growth will occur in Denver. And so, you know, the mountains give us that geologic barrier to the west that doesn't, you know, might as well beyond a coast, you know, you just can't grow west.

Q: Yeah.

Mark Harding – President and Chief Executive Officer
Well you can, but it's, you know, it's a beautiful people grow west.

Q: Okay. And final question for that target area, that universe? Are you the only source for water for undeveloped land now or are there other sources for water?

Mark Harding – President and Chief Executive Officer
You know, I would say we're not the only source. But I like our position, you know, we're the cheapest source, we can give them, you know, one tap at a time, you know, they can buy $30,000 tap rather than spending hundreds of millions of dollars to develop the position that we've developed over the last 30 years.

Q: Okay, thank you very much. Great job.

Mark Harding – President and Chief Executive Officer
Thanks.

Operator

Thank you. [Operator Instructions] Mr. Harding, I'm showing no additional questions in queue. Do you have any additional or closing comments?

Mark Harding – President and Chief Executive Officer

So I'd just like to thank you all for your continued support. You know, we'll post this on our website and you can continue to listen to it or refer back to it. And for those of you weren't able to make it on the call, if you have a question after listening to it, don't hesitate to give me a holler. And I'd like to wish you all well, stay healthy and keep an eye out. We got plenty of pedal left in this for the next few years. So we're excited to continue to deliver results. So thank you all.

Operator

Ladies and gentlemen, thank you for your participation. This concludes today's event. You may disconnect your lines and log off the webcast at this time and have a wonderful day.