Transcript of
Pure Cycle Corporation
Third Quarter 2022 Earnings Call
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Participants

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Analysts

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Presentation

Operator

Good morning, ladies and gentlemen, and welcome to the Pure Cycle Corporation Third Quarter Nine Months Ending May 31, 2022 Earnings Call. At this time, all participants have been placed on a listen-only mode and the floor will be opened for questions and comments after the presentation.

It is now my pleasure to turn the floor over to your host, Mr. Mark Harding, President and CEO of Pure Cycle. Sir, the floor is yours.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation

Thank you very much, Jenny. I'd like to, first of all, say, good morning, and welcome to our nine months 2022 earnings call. We do have a deck for this call. If you go to our website, purecyclewater.com and in the Investor section, you'll find the link on that that will allow you to follow along with the slides that we have here. With me today, I have our CFO, Kevin McNeill, who will overview some of the financial metrics for the nine months ending. I also have Dirk Lashnits, who is our Vice President of Land Development, and I think he'll highlight a little bit of our progress on the Phase 2 of our Sky Ranch development.

After we'll do the deck and after the deck we'll have a brief Q&A for some of the color of the quarter and the year, and maybe how we're going to close out our fiscal year. So if you have any questions, please hold those to the end.

With that, let's get started. I'll talk about our Safe Harbor statement to say that the statements that are contained are not historical facts or incorporated or I referenced in this presentation our forward-looking statements, I'm sure most of you are familiar with the forward-looking statements and the Safe Harbor statements. So that's we'll get the lawyers out of the room we can start the presentation. I'm going to just give you most of you are probably fairly familiar with the company, so I'm going to blow by kind of the overview of the company relatively quickly.

What we do is we operate in really multiple complementary business segments and really the underpinning of that segment is our water, wastewater resource development segment, where we're providing water utilities in an area where we own a portfolio of water rights, which is an accomplishment, because it's an area that doesn't have a lot of water, and water certainly getting a ton of press these days, particularly out west, with the limited supplies and the ongoing drought that we have.

Our portfolio has the capacity to provide about 60,000 SFEs, we got a little typo in the slide there. So it's actually 60,000, not 600 or 60,000 with missing decimal, 60,000 single-family equivalents, primarily in the Denver Metropolitan Area. We provide water and wastewater service to land development that we are developing where we also have a land development segment and then also provide water to other customers in the regional area.

Our land development segment is focused on a particular piece of property in the I-70 Corridor, which is probably the most attractive and sought after corridor in the Denver Metropolitan Area. It's directly south of Denver International Airport. It's about 4 miles south of Denver, DIA is right along the interstate, where we have an interchange that accesses our property. We have a property interest about 0.5 mile frontage along the interstate.

So in addition to the residential opportunities, where we have about 3,000 to 3,400 residential opportunities, when you take a look at the multi-family development and a couple of million square feet of commercial, retail, industrial uses on that. And we're developing residential commercial lots for national homebuilders and we provide water and wastewater service to those.

More recently, we're holding back a few of the lots that we're developing within our own community and we're actually moving into building homes on that. We will contract for someone to build those homes for us and we'll keep those homes in our portfolio and rent those out to the marketplace as single-family rental segment of the business and that's a nice growing segment for us and certainly a profitable segment where we can capitalize on the equity value that we have on the water side, as well as the Land Development side.

So, with that, we'll move to the next slide. I want to talk a little bit. This is new to our presentation about our ESG efforts, environmental, social and governance. We have recently brought in a new ESG initiatives specialist and she will be working to bolster the company's actual written format of ESG.

The company is a very environmentally sensitive company and one of the things that we found is that you all don't know that and the rating agencies necessarily don't know how we go about doing that. But as we take water and we process that water, we bring that water back as wastewater and we reprocess that water, we are taking and using and reusing every drop of that water.

And what we want to do is really highlight that policy and that investment that we have, so that the rating agencies understand how seriously we take the environment and social and governance aspects of that. And so what you'll see growing on our webpage is that ESG tab out there. It's new to the web page, but you're going to start to see a significant amount of documentation that follows through on that. On the E, we will update our environmental policies, we will be begin by assessing, tracking and disclosing energy management usage, network efficiencies, water use and wastewater management. And so those are going to be the key aspects of the environmental tab.

The social update or human rights policy, we've improved component of that S score by 6 points already, continue to develop a labor health and safety policy, track our employee satisfaction, water affordability, water conservation and then diversity within the company.

And then we continue to update our governance policies, we have a very robust governance policy and we really want to kind of show the marketplace and NASDAQ and the rating agencies, all of the components that we have as part of our policies and our charters. So, look for more of that as we continue to grow and you'll start to see a bit more of that within ISS and the rating agencies attributable to that.

So I'll start out by just giving you a quick overview of our water segment. We have, as I mentioned, a portfolio of water rights, we have about 29,000 acre feet of water rights. It's a mix of groundwater and surface water, with a capacity to serve about 60,000 connections and we raised the connections by an average of single-family, how much water single-family house uses.

We have some very valuable surface rights and we develop sort of our system cradle to grave where we own the water, all of the infrastructure that is used to divert that water supply, treat that water supply, put it into a distribution system, we collect two fees for that, we collect connection fees, which are one-time fees typically paid by the homebuilder, which gives you access to the water and wastewater systems. Our current tap fees are listed here, they're about a little more than $32,000 now. And then the homeowners will use that water supply, that's your metered monthly water bill that typically generates about $1,000 per connection on the water side and about $500 per connection on the sewer side.

So you have water and wastewater monthly connection or monthly usage fees. We collect that wastewater. We bring that through our water reclamation facility. And we put that back to its full reuse capability and then we have a separate distribution system that takes that out for reuse either to outdoor irrigation uses through the parks and open space areas that we have in our Master Planned Community or we take that to some of our irrigation or industrial customers. So we're reusing using and reusing every drop of water that we divert from our system.

A little bit on the water infrastructure, we continue to invest in our water utility segment. So it continues to grow. We're a little over $60 million of assets in that side and a broad portfolio of assets. We have two wastewater reclamation facilities, transmission lines, storage facilities wells, just the broad portfolio of that and the mapping kind of shows you a relatively large footprint where we're providing water over about a 15-mile width of the county that we are in and we're providing it all the way from north to south in the county boundaries on that.

We continue to grow our customer base. So we've got a little over 700 customers. That metric may not include the conversions of our commercial customers. So we'll continue to refine when you get a commercial customers not just one single SFE, that – there can be multiple SFEs and that's how we do that conversion of single-family connections. But we continue to add to that not only from what we serve directly in the service area that we have at Sky Ranch, but also in our Lowry service area, as well as in the Wild Pointe service areas that we have.

Talk a little bit about oil and gas. As we've all painfully aware of the price of gas at the pump, oil is much more robust than it has been in recent years and that activity is translating into increased activity in all areas that have oil and gas. And in our particular area, we get a lot of this activity from Shale Oil and Colorado has a very active Shale Oil play in the Wattenberg Field and the Niobrara Formation.

There's a number of different formations, so there's a potential, as you take a look at, it 40 acre spacings, which is the downhill spacing that operators are typically liking for their field development side. There's a significant capacity for developing oil and gas in this region.

This particular area has been derisked by a number of operators, so they are fairly comfortable with what the yields of these wells are looking like and we supply a lot of water. These wells when they do their well stimulation and fracking, these wells use a lot of water and they use it all at once. So on average we make about $250,000 of water deliveries per well.

Operators are now really working field development type development pads as opposed to hold-by-production lease drilling. So, each of these pads are seeing anywhere between eight and 12 wells per pad site on it.

So the regulatory climate has been shifting here in Colorado. It's been relatively predictable for the last several years, and with the price of oil, you're seeing a lot more activity in this area. You'll see good revenues for us for 2022 and we look to see 2023 and 2024 continue to add to that portfolio. So that's a big customer for us. It does allow us to continue to invest into our water and wastewater assets so that we continue to expand those systems.

Just briefly next, one of the things that we have highlighted is, kind of where the metropolitan area is and where the company's assets are in proximity to growth of the metropolitan area. And in the big aerial map, you can see kind of the pink areas, which will be our Lowry Service area and then also towards the top of that will be that pink area, which will be our Sky Ranch area. So those are the areas that, certainly, Sky Ranch that we have our active Master Planned Community going on.

But you see by the drone shot here, how quickly the metropolitan area has grown out to our service area. And so we're very excited about that that continues to provide a strong pipeline for us for future growth opportunities. And as this property continues to urbanize and the landowners in this area continue to look for how they're going to meet the growing demand for development here in the metropolitan area, this I-70 Corridor, this Arapahoe County area is probably among the most attractive in the Denver Metropolitan Area.

So, with that, what I'm going to do is, I'm going to turn the mic over to Dirk Lashnits, who handles our Land Development activities and kind of give you an update of how we're coming along with our Land Development. So, Dirk, I'll let you take it.

Dirk Lashnits - Vice President, Land Development, Pure Cycle Corporation

Good morning. Dirk Lashnits, I oversee our Land Development and I'll give you a quick overview of our Sky Ranch project, and repeat some of what Mark has already mentioned. Sky Ranch is our 930 acre Master Planned Community on the east side of the metro area. This project will probably develop in about 6 phases over the next 7 to 10 years. We're complete with our first phase and underway with our second phase right now. So we'll get into that in later slides a little bit.

At build out, we're looking at somewhere between 3,000 and 3,500 residential lots. We have about 150 acres of that 930 acres is a commercial parcel that fronts the I-70 corridor as Mark mentioned. And then as the rooftops grow out towards this area that commercial will start coming online. So we hope to see some activity along those lines in the next year or two.

And then our proximity to town like we said that the I-70 corridor is the main east-west thoroughfare through the metro area and we're we have an interchange right off of that. And just a few miles from our E-470 Toll Beltway that kind of connects the whole metro area and real close to the airport as a business corridor.

Next slide here. So our first phase, we started this in 4 or 5 years ago, 2018. It's wrapping up right now. This is an aerial image. And if you look at the top of that image, you can see some brown lots up there, those of the last remaining lots that are getting built out on, so 509 lots out here. We're probably about 475 occupied houses now. And all of our taps have been paid. So all the houses have been – all the lots have been sold, and to the builders and they're building the rest of the houses out there, I think that'll wrap up this year.

Quick highlights on the financials out there. So we cost us probably about $35 million, $36 million to build all these. We had that recognize the revenue from what we sold to our builders, that's $36.7 million that we received for our lot payments. We did a an initial bond offering out there, that's the $11 million of revenue through our bond through our district that we've received, and then there's another $20 million sitting out there for future collection on taxes and other future bonds. So revenue we got about equivalent revenue on our lot sales, to our costs. And then we have the reimbursable our margins there.

And then the water side, the $14 million on our tap fees. And that translates into our regular monthly water customers. Second phase of Sky Ranch underway right now. So this is 850 lots. So about 1.5 times the size of our first phase, we're in the midst of turning over our first lots to our builders right now, so started building houses out there. This will roll out in about 4 intervals, roughly 220 lots, divided into 4 phases. So our first phase of 220 or so is what we're building right now. This phase also includes a new charter school that will serve the community and has some land set aside for a new rec center.

We should start seeing the first residents out here first customers on our water system towards the end of this year. So, probably, first, maybe first quarter earliest or second quarter of our fiscal year. We got a handful of lots set aside in this phase for our single-family rental lots that we'll be developing. So the estimated lot revenue out here have $70 million as compared to our first phase that was around $35 million. So it's about twice as much revenue for this phase and not quite the same amount of lot. So there's a little bit of appreciation there.

New tap fee number there was $20 million. This next number the $61 million of reimbursable is an aggregate that includes the first Phase 1, and that $11 million was our first bond. We'll be looking to do another bond on this phase here in the near future to help recover some of those reimbursables. And then our development costs on this space, our costs are up a little bit from our first phase and just tracking through the different phases of the project.

That's it for construction and I'm going to hand it over to or back you to – back Mark for maybe some financials.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Yeah. So let me just detail out a little bit of the financial metrics on these 2 phases. So as we were talking about from the first phase. Phase 1 had about 509 lots. This one has a broad mix of product classification. So we've got four different, we got 3 new builders, one returning builder, really building a very strong variety. We had a couple of different product mixes in the first phase. I think we have 6 different product mixes in the second phase. And we're delivering this in increments, as Dirk was mentioning, almost 4 equal increments, not exactly you will, but that allows both us and the home builders to manage how we're doing the horizontal costs. And that's an important component.

Each builder under our lot development agreement format is really our partner with us on developing these lots. And so we get paid 3 equal installments on our lot delivery agreements, where we deliver a plan that lot. We will get that first third payment, then we use those funds to be able to invest into delivering the water sewer systems here.

And then we get the second payment, we use that second payment to really finish out a lot of developing the roads, curbs and gutters. And so that really does partner us with our homebuilder partners to make sure that that heavy lift of the horizontal infrastructure is done concurrently with their purchase of the lots. And these kind of detail that out is how we're going to expect to see that over that second phase with the gross proceeds are and then also how the reimbursable is accrue to that.

And, as you build a community, those investments tend, you always have a bit more of those infrastructure costs as you continue to build that. So we probably see a bit more infrastructure in these first 2 phases, then are needed necessarily just for those phases, just because you have that expanding network of infrastructure, the drainage infrastructure, the road infrastructure, those sorts of things.

Moving to the next slide, just kind of going to show us how we're going to complete out this first up phase, the 229 lot. So we've had the first 2 deliveries where we've delivered the platted lots, the wet utility lots. And then the big takedown will be this third takedown. We do have some finished lot delivery agreements with one of our builders. And so that's why that third segment is going to be so much larger than the other. And we do expect that will deliver all 229 lots this fiscal year. So you see that data in there, which we'll see a fairly robust fourth quarter cash flow on this thing and really bring that, I think, we showed you a metric in there, 67% complete on our first phase. We will be able to get that to pretty close, we won't be 100%. But we will be substantially complete on the lot deliveries for that in the third payment.

I want to talk a little bit about the charter school. That's one of the things that we saw early on is the importance of having a neighborhood school. And so we went to the local school district which we happen to be on their far western border. And as this shot shows you, our first phase actually fell into a different school district. Our school district boundaries are really agnostic to the city municipal boundaries. So they have their own separate boundaries.

And so our first phase was actually in the Aurora Public School District. The rest of the property fell into the Bennett School District, which is a bit farther east of where we are. And what we went to them with is to say, listen, we appreciate that we're on your far western boundary here. And it's a bit challenging for us to serve this, we'd like to talk about how we are able to have a local school here where the students at Sky Ranch can walk to school, and they were very supportive of that. so we worked very directly with the Superintendent, the CFO and the Board of the Bennett School District, and we're able to get an authorized charter and then we ended up interviewing a lot of different charter operators and partnered with a group called National Heritage Academy.

National Heritage Academy is one of the larger private charter school operators in the country. They have over 100 schools in 9 different states serving about 60,000 students. And we were excited that we had our original groundbreaking for that we actually probably broke down a little bit earlier with some of the grading work out there. But we actually were able to get some elected officials out for a groundbreaking ceremony. Our K-8 will open up in August of next year. And then we'll actually probably serve grades K through 7, and then incrementally add grades each year, and then open up the high school in 2025. So we think this is a true tremendous amenity for the region for our project for the Bennett School District for National Heritage Academy. And so it's a true success for all of us. And we're very proud to bring this to conclusion.

I'm going to turn the mic over to Kevin, and he's going to detail out some of the financial results of the quarter.

Kevin McNeill - Vice President and Chief Financial Officer, Pure Cycle Corporation

Right. Thank you, Mark. Yeah. So the slide we're on now obviously summarizes our single family rentals that Mark talked about earlier, which is new to us from November, we've got three built rented that you've been occupied since November. We've got a fourth one under construction right now. They'll back up a little bit – this is just some metrics on the market. You'll see the rental market is still continuing to be strong, we expect it to stay that way for a number of years. This shows us some pro forma information on what individual rental house looks like. This is based really on the first three that we have running right now. And this is what we're experiencing. And we expect this to continue for the fourth one and the next 10 into the next 46 that we have planned for the whole second phase of the developments.

Like I said, right now, the first three are fully rented, going pretty well, I think as well as we expected them to go. This is a little timeline that shows you how they progressed. So the first four pictures on the left show you how that the first three houses were built, the fifth picture over there on the far right is the fourth house, that's under construction windows just got put in yesterday, which is pretty exciting to watch. And then the next 10 – and those four are all in our first phase. The next 10 are in our second phase in Phase 2A have we signed a contract with the builder, we have them they're getting a stake in them and start construction on them probably this month, with an expected delivery of those 10 phased in over the 6 months after that. So they'll phase about – a delivery of about two rental homes every 2 or 3 weeks for us. So we don't take 10 on at one time will we'll be able to load that into our portfolio in hopefully in a progressive manner and not overwhelm our staff with everything.

Looking at then – so the numbers, so for the nine months ended May 31, which we filed our Form 10-Q and had an earnings release last night. So hopefully everybody had a chance to look at that you can see our revenue is pretty in line. So the top left chart is our nine month ended revenue for this year compared to the last 4 years. And you'll see we're in line with the last few years. 2020 was a little bit higher, which was mainly because Phase 1 was in full swing and we were selling a lot more taps. We had a lot more for progression going on the construction there.

Phase 2 then has started taking over. We're starting selling taps. This quarter, we've sold about 40 of them so far this year, which is predominantly model homes and some of the first homes and we'll have a lot more hopefully selling in the next few months. Taps sell at permit – at building permit for the home builders and not necessarily with the lot takedowns. As you can see that's about $20 million in operating income is up a bit for the year-to-date nine months ended about $300,000, which is partially due to the increased revenue. Also partially due to the – we had earned income credit that we recognized for retaining employees throughout COVID. That was about $200,000, which is obviously positive for us.

Net income looks a little bit screwy. It looks like a drop but in last year. I'm not sure, if everybody remembers but we had a one-time pick up where we are allowed to recognize the public improvements, the amount that we are going to get reimbursed that up until that time we weren't sure the CAB would be able to reimburse us if there was enough property tax revenue driven to do that. And so last year, we were able to prove that it was, because Sky Ranch was doing so well. And so we're able to recognize about $16.5 million last year in other income and so that skews the results a little bit.

So you can see the $4 million is pretty close to on track with a few years ago. And we expect that to close a little bit higher during the last quarter of the year due to all the lot sales we expect to have for the close outs. You can see the information across the bottom in our 3 segments that we report. So obviously we have $61 million of water assets as Mark talked about earlier. We did delivered 59.8 million gallons of water during the quarter which was a lot obviously to the Sky Ranch residents, Wild Pointe residents, and then hydraulic to the oil and gas operators.

This is looking back at how we did for fiscal year ends for the last 5 years. So this obviously doesn't have this year, fiscal year out there. But we did have we do have a projection in there for our revenue based on our 9 month ended May 31 revenue and where we're expecting the builders to come in the last quarter. So we're looking at – we're hoping to post revenue. Right now, we're projecting pretty much in line with the last few years, obviously, a little bit higher than last year. Some of that is tap revenue, some of that a big chunk of that is the finished lot deliveries, especially DR Horton coming in hopefully during the year.

As you can see them the net income that we're projecting is about $1 million, which again is lower than last year. But that $20 million last year, as you can see, in that note was very much impacted by the $16.5 million of net public improvements that we recognized. So if you factor that out, we're obviously going to exceed that this year. Gross margin, we didn't put in a projection just because it's a little more difficult to put in project. This is our balance sheet.

So this is what you'll see in our Form 10-Q that got filed last night. You can see it's pretty consistent compared to year end with the public improvements doing increase. As you can see, the $16 million is still current. The CAB is working on some financing right now. So hopefully that will change. But public improvements do continue to increase there, you can see the long term up from about $8.7 million to $19.3 million, which is a good thing because that means development is moving along.

And Dirk and his team have done a great job on the second phase and moving along despite obviously slowdowns with continued COVID, supply chain issues and everything else, but it's progressing nicely. The rest of the balance sheet is pretty consistent with the year end. And I think that's from our standpoint is exactly what we want to see.

The statement of income of operations, obviously, we have the 3 months ended on the 2 left columns this year compared to last year and then the 9 months ended between the two. And as you can see that I'll draw your attention to the lot sales, if you look at the 9 months ended 2022 compared to 2021, 2021 at $3.3 million, this year we're at 5.6, which is really is all that Phase 2A as it progresses, with the three of the builders – three of the four builders, we recognize revenue as a percentage of completion.

So as construction occurs, and as we finish, what utilities in all the public infrastructure, we recognize revenue on those contracts, not necessarily in line with the cash. So that we expect to have a fairly significant increase during the fourth quarter as we finish those lots for our finished lot deliveries. And that will have a big impact on the revenue as we continue forward. And so we're expecting that in the fourth quarter. Not to put any pressure on Dirk.

And then you'll see if you continue down, obviously, the general administrative expenses remain consistent. They're in line with that which really represents the operating costs of the company and the overhead and everything else. And as you can see like we've been talking about that recognition of public improvements down at $17.2 million, which is a little different than the number we talked about in the previous slide, because of the tax effect of everything. That's really the number that looks great last year, but skews the numbers this year and makes this year look not quite as attractive. But it really is that was a one-time catch up just an accounting thing and doesn't really have much to do with the performance of the company.

So hopefully, that'll normalize itself out in the next year, because we'll hopefully continue looking at the way we're looking at now, which is running at the receivable. I think that's it. And so I'll turn it back over to Mark if he has any final comments.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation

Yeah, I just want to highlight just a couple of things on the financial metrics. And as we've talked about this in the past, just to reiterate for those of you that are new on the call on these public improvements, so what we do is we build the roads, curbs and gutters and the drainage and those are really owned by the local municipalities. And we're able to get reimbursed on those through the tax base property taxes. Colorado is kind of a growth pays its own way state. So each individual development has property taxes, they have their own investment in public improvements, and the local ratepayers and the local residents that pay those taxes. And so the reason it was a little wonky for us on the front end of this thing is that we were deferring the potential for those revenues rather than recognize them on a periodic basis.

And so once we were able to demonstrate to our auditors we had full confidence, but our auditors may have wanted a little bit more definition on how we were going to get these reimbursables out. And it's really standard industry practices to how this does occur not only in Colorado, but across the country. But what's the local municipal jurisdiction was able to get some assessed value from the homes that were there from the residents that they were there from the tax collections. We were able to bond that. And so the reason that we recognized all that revenue very lumpy last year was due to that.

Now, what we're doing is we're recognizing those revenues incrementally. And so those are growing, and you're going to see that much more stabilized revenue stream on our financial reporting. So that's why some of those year-over-year metrics look a little bit awkward is that previous years of that, we accrued that and then we recognize that all at once wants to add that first bond issuance. This time, we're accruing that in the income statement incrementally showing it as a receivable on our balance sheet. So that's the real differentiator in how that reporting looks for you all.

I want to open it up – those kind of our prepared remarks. I want to open it up to some Q&A. And just so that I'll preempt you all I'm going to ask the first question, which is kind of obviously be, what impacts do a rising interest rate have on your development? And so, as we're developing our second phase, we've got all 850 – well 804 of the 850 lots contracted for with all national home builders. And what we're seeing is in this Denver market, one of the advantages that Sky Ranch has and us in this marketplace is, we are probably one of the most affordable master planned communities in the Denver marketplace.

And our homes are starting out, when we originally opened up the community; they were starting out in the high 300s. Now they're starting out in probably the high 400, 500. The median value for homes here in Denver metropolitan area is north of $675,000. So we are in that affordable metric marketplace. I've talked with all our homebuilders and a number of other home builders and some of the things that they're seeing are a weakening in traffic for homes priced above that 600, 650. That's where, they're seeing a little bit longer time on the market for those homes. And that's obviously a function of the traffic, the number of buyers and the interest rates on those.

And some of that traffic is flowing to prices, homes that are priced below 600, and so all of our homes are going to be in that below the 600 market. We do have that's one of the reasons why we have this lot delivery agreement structure with our homebuilders so that we're working together with them. So that we're not taking on this large inventory of lots, they're not taking on that large inventory a lot. So we're delivering the plots on a real time basis. So I would say, so far, our traffic flow seems to be fairly consistent with our first phase, we'll see how, as they start putting up these homes, a lot of the builders are going to build the homes on spec. And they'll build, say, maybe 6 to 10 homes on spec, have those as inventory and then continue to build them incrementally each month so that they can kind of maintain that move in opportunity for their homebuilder customers.

So with that, if you need a little bit more color on that, I'll certainly try to give you any more perspective if you want other information other than that, but I'll turn it back over to Jenny and we can see if you all have any questions for some color.

Operator
Thank you. Ladies and gentlemen, the floor is now open for questions. [Operator Instructions] Thank you. Your first question is coming from Mr. Bill Miller, who's a private investor. Bill, ask your question, please.

Q: All right. Good morning.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Very good morning, Bill.

Q: I'm wondering how you're going to benefit from or get hurt by the inflation, obviously, you have your energy area which is producing inflation and how many wells do you have on your pad? And what is the production of revenue?

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
So let me kind of parse that into two segments. The inflation question, one of the things that we are seeing a bit increase in costs of deliveries in kind of roads, curbs and gutters, anything that's energy related concrete, asphalt, those sorts of things we do see a bit of that cost increase. We have some inflators in our lot delivery contracts with our homebuilders that naturally anticipate inflationary measures in there. So each of our lot contracts that we have we did put in a 4% inflate on each of those. Inflation is rising at a higher rate than 4%. And so bit on the low side of that, but we are keeping up with our builders on the inflationary side of the cost that we're going to see in that.

Our homebuilders are seeing a mix of inflation. Lumber and those have prices have stabilized or come down a lot of supply chain issues in their spot and some of the supply chain issues, garage doors, for example, seem to be one of the more challenging metrics in there. But they've managed that fairly well. And we see that necessarily through our individual homebuilding efforts with our home builder, where we were taking a look and managing that with our builder to say, hey, I can take inventory of windows, I can take inventory of garage doors here. And so they go out, they get those ordered for those long lead time issues. So it's a management issue in terms of each of the homebuilders.

I think the labor shortage issue has kind of worked its way out. For most of our homebuilders, while I think they would love to have a stronger, robust, more robust labor chain on there, it does not seem to be prohibiting their production on any side of this thing.

The other question in terms of the energy side, we do anticipate, we have another pad that our operator is looking to start construction on later this year, and drill out the remaining balance of wells on Sky Ranch, I think they're forecasting something like 12 to 14 wells, they might have, say, 8 wells, that'll be on drilling our mineral interests going through one direction, and then maybe another 6 that drill wells into the neighboring property owners, and so what we tried to do is work with neighboring property owners to limit the number of pad sites. So that sometimes they're going to be drilling wells on their pad sites that pool our mineral interest, sometimes we'll be drilling wells on our pad site that pools their mineral interests. And really, that's the combined interest of both of us.

I would say that the energy side is going to be steady, a consistent increase in wealth, but not off the charts. We don't see it exploding in terms of the number of wells that get drilled, I think it's going to be a consistent increase in the number of wells that get drilled, and the number of wells that we're going to be fracking, and it's really a function of the fact that everybody's competing for rigs, everybody's competing for frack crews. And so, our operators are competing with everybody else. And I think that they're looking at it as to go as fast as they can, because the prices are good. But the whole capacity within the system is going to be a bit constrained by the number of rigs that are available. So I hope that answers your question, Bill.

Q: Yeah, great. Tell me about the ability to raise your rental income? I mean, you've got a refresh coming in November, can you raise the rents? Or is that not possible? Or how do you…

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation

Oh. Yeah, I mean that's kind of why we look at having annual leases on this. We want to make sure one that the tenants like us, secondly, that we like the tenants and that we're fairly priced. And so the advantage I think that we have in the single family rental market is that we're carrying forward tremendous equity in both the lot itself as well as the water utilities. And the first three were a classic example of that, we held the lot value for ourselves. We went and contracted to build these homes for $330,000. They appraised at around $550,000. And then we were able to rent that out as if it were a $550,000 house, which gave us significant margin in the – making sure that we're using a little bit of leverage within the company. So we financed the vertical component of that $330,000 and not only does our rent cover that, but it gives us incremental margins.

And we do want to keep conscious of that that rental market. If homebuyers are looking at the demand for single family homes is as high as it's ever been. The demand for buying single family homes is as high as it's ever been. If one of those weekends, it's going to be an interest rate sensitive market where the demand for renting those single family home or buying those single family, people may wait a few months to see what interest rates do or how the change in interest rates are.

When you look at historical trends, interest rates at 5% to 6% are historically low. And they're not low comparison to a 3% interest rate. But they're certainly not what interest rates have been in the past being 8.5%, 10% on those things. So I think it's going to equalize in the marketplace for buyers, they're going to continue to aggressively pursue that. I think the single family market segment is going to continue to grow, whether that's going to be for rentals, or whether that's going to be for purchase. If we continue to see growth in the rental side competition in the rental side, you're going to see rental rates continue to appreciate. We will continue to monitor that. We will continue to maintain a market segment in that area where we're competitive. But we also want to have a good long term tenants in there so that we can continue to maintain our portfolio in house.

Q: Well said. Thank you.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Thank you.

Operator
Your next question is coming from Elliot Knight of Knight Advisors. Elliot, over to you.

Q: Good morning, Mark and Kevin.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Good morning.

Q: Expanding on the build to rent, that was my question about and you've largely answered it. But in a rising rate environment will Pure Cycle's profit be impacted, because you began this program at a period of when interest rates were very low? Will your margins be squeezed by the rising rent, the rising interest rates? Or do you think rising rents are going to more than offset that? Anything you could say on that would be helpful?

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Yeah. So I would say that the rising interest rates don't directly impact our lot prices. Although if it takes more income to qualify for the same value of home. It does impact the builder's ability to buy home or lots at a certain price. And so that's where I think you're going to see a lot of the weakening, softening in the marketplace for lots that are going to be $130,000, $150,000 lot that delivers a $650,000 home, $700,000 home kind of that median home value.

So the interest rate sensitivity does have an impact in home prices. And by virtue of home prices, it can correlate down to the price of a lot. But that's kind of where I think we have our competitive advantage that we're delivering lots entry level marketplace, our lots, our average lot is around $100,000. So we're substantially not just a little bit cheaper, we're substantially cheaper than our next nearest competitor for that. When you take a look at rising interest rate environment into the rental market that does impact that and the cost of money continues to impact players that are buying homes and renting homes at fair market value.

And so again, we're going to be positively positioned in that, because we're carrying forward equity value that we have in the lots and the water utilities, to the tune of 40% of the lot or 40% of the home value. So that gives us a competitive advantage. Yes, we want to be competitive, we want to make sure that that asset is producing the right revenue for our shareholders on that. But we also want to maintain consistency with income on that. And so there's a balance there. Where we want to continue to be competitive will continue to be market based on our rental rates and that continuing to be market based on that will continue to improve our margins. And so when we already start with good margins, rising interest rate environment will help us in that area.

Q: Okay. Thank you.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Yeah.

Operator
[Operator Instructions] Okay. There appears to be no further questions in the queue. I'll now hand it back over to Mark for any closing remarks.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Okay. You are very kind to me today. I'm very appreciative of that. I'm going to throw a question. I know everybody…

Operator
Do you have a question, Mark.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Hello.

Operator
We have another question if you want to take it.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Sure. You bet.

Operator
It's from Greg Balachowski [ph] of Benchmark. Greg, over to you.

Q: Hey, Mark. How are you?

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Great. Thanks. How are you, Greg?

Q: Good. Good. Yeah. I'd say I jumped in there at the last minute. I just kind of had a quick question. Maybe 2, the first one is on the economics of the single-family rentals, it obviously looks good and kind of branching off of that, I'm sure you're aware of multi-family is a rather attractive asset class. I was just wondering if you guys had given any thought to potentially either converting or adding additional capacity in future phases to potentially build a 50, 100, 200 unit multi-family complex that the company could retain for their rental program as well.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Good question. And I will – let me answer two phases. One, we do have a multi-family component to the overall master planned development. And I think it really positions itself between our commercial and our residential. So it'll be in that area on kind of the lower half of that 150 acres that's our commercial side and transition between where we go to the detached residential stuff. It may be as many as 450 units and would we carve off one of those buildings for the company itself, one or more of the buildings for the company itself, entirely within the scope of opportunity with what we're looking at here.

I think the multi-family is a little bit different property management than the detached single-family and so we got to look at that fairly carefully as to how we would manage that, whether we would manage that in-house or contract or something like that. But it is within the range of possibility. Right now, we're going to focus in on a very diverse and wide product mix for single-family and we will have very big homes, where we have 4 bedroom, 4 bathroom, detached single-family rentals and we understand that market, there's a strong, strong market for that right now, just because of the work from remote where we can have one or maybe even two office environments for people that want to work from home or even kids and office from home.

And then other product classes where we'll have some paired product, we'll have some townhome product, we'll have some smaller lot product, 35-foot lot product in there. And so when you start to see a very broad range of product classes and you'll have a broad range of renting entry points on that, you really do have kind of robust rental, current income driver for the company. So we do like that segment.

I would say, the real advantage for the segment and this is something that we highlight a lot is, we may not be diving into the single-family rental market, if we were going out buying the score at fair market value, it's probably not the highest value thing that we think we're good at doing is to define where these market home, where the homes would be in the highest market potential for that, but because we're adding value to the community, because we're adding value to each of our individual lots, that's where we think that this is so compelling for our shareholders is that it not only increases the value of the asset class, these homes are appreciating at 5%, 6%, 7% and in Sky Ranch's example, because we started the community, you've seen as much as a 40% increase in value of the homes from our Phase 1.

And so we're adding that value to the community through our parks, through our trails, through our opened space, through our commercial development, through our charter homes, our charter school. All those things are increasing the value for our homebuilder partners, which we think is terrific. It's increasing the value for our lots. It's increasing the value for our residents out there. And so all of those things are terrific for us and we like how this segment is complementary to the value proposition in there and multifamily can be a component of that, Greg.

Q: Okay. Awesome. Awesome. And then just one other question I didn't notice, it was kind of tucked away in the subsequent events section that there was a minor, I mean, I think, it was like a $3.5 million acquisition of some, I guess, a few 100-acre-feet of water rights. And, I guess, I just wondered if you could expand on that in terms of, one, kind of what the strategic benefit of that is; and two, if in any way you can extrapolate from that valuation paid in relation to the remaining or the rest of the company's existing water assets, because I guess one of the biggest problems people run into is somebody coming across this company, you look at the portfolio of 29,000 acre feet and a lot of people have difficulty putting a real value on that. So I'm just wondering if you could maybe, if there's any read through in terms of the valuation or just in general, how you would tell somebody to look at that?

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation

Great question and I'm glad you brought that up. It was going to be a component of the question that I was going to ask or a rhetorical statement that I was going to answer for that. You're right, one of the underpinnings of the company continued to be a water resource company and the value of water as it relates into water short region. And we did buy a small addition. It was three additional wells that we had, that were in proximity to the two wells that we bought 3 years ago. And so we liked that particular area, it consolidates a bit more water in that area for us.

We found a good value proposition in there. It was a seller that we had been talking to for a number of years on that. And in acquisitions, whether that's going to be land or water acquisitions, a lot of its relationship oriented, a lot of these are legacy owned by families through generations. And so sometimes it isn't how much or what's going on in values or market segments, it really does fall into the timing of the individuals. And so that was an opportunity for us.

The value that acquisition, I think, I never like to say, oh, well, we did great on that acquisition as compared to the seller. We try and be fair and buy things at fair market value hold those things and we try to be fair market value and timing of our acquisitions more than we try to be really a hard driver, hard bargain driver on the purchase price of any one assets. And so, as the market continues to see these inflationary pressures, we're seeing a lot of loosening of that conversation. And that's a classic example of that, we were able to pick up some wells that we had our eye on for a while, the seller did come through and really was able to sell it to us on a quick close and we were able to get that one put together.

I think we bought those assets for around $10,000 an acre foot and we probably paid about $10,000 an acre foot for that water 3 years ago. So I think that that was a good acquisition for us on that particular site. I think that water in general has increased in value. So we want to be conscious that we do have a large portfolio. But we also want to be conscious that, once it's gone, it's gone, and there's not a lot of opportunities to continue to grow that. And so our tuck-in acquisitions are going to be areas that are strategic for us and those were certainly one that was strategic for us.

Which then leads into and I'll just pontificate a little bit about, how do we look at capital allocation? And when we look at acquisitions like that water acquisition, when we look at acquisitions like additional land acquisitions, when we look at opportunities to deploy capital for shareholders through a share buyback program or through a dividend program. All of those are good options and things that we evaluate in relation to our liquidity.

And one of the key drivers to management, as well as our Board is to invest in the business lines that provide us that ongoing revenue. And you see that right, you see that through our financial statements, quarter-over-quarter where that liquidity – excuse me, I got a frog in my throat here.

But you see that liquidity will adjust depending on the timing of delivery of a plat, depending on the timing of delivery of what utilities or the timing of delivery of those finished lots.

And while our cash position starts to weaken through the inter periods of those contracts and these particular contracts really cycled out fairly well for our year end. So you're going to see those cash balances refresh at our fiscal year end with that final lot payment and the finished lot delivery device of one of our finish line contracts on that. You sort of look at, and say, as investors, how do we evaluate those opportunities from a high margin business? Water is clearly that.

We continue to evaluate opportunities there, as a high barrier to entry business, you got to know what it is that you're doing, complicated, you have local issues, you have local management district issues, so things like that. We could make an argument. There are a few businesses that provide better opportunity for sustainable revenue then the water business in general, because that's a perpetual customer. They're always going to pay their water bill. So we liked that opportunity segment out there.

Our second appetite in this metric is land appetite. And to be sure, we've been in an expansionary housing market, Denver has been among the top metropolitan areas for housing starts and home appreciation. And while those metrics alone are noteworthy, what we have is an advantage over the run of the mill developers is, we have that portfolio of water where we can bring that water to a particular piece of property, and by doing that itself, it increases the value of that land.

So we do have our nets out for land acquisitions and there are opportunities and those conversations are slightly different now than they were maybe 6 months ago. And so we'll see how that how that creates those opportunities for continuing to grow the company on the Land segments side. And these opportunities don't just lead to good returns, but they lead to generating ongoing recurring revenues and terrific margins for us in that, so that's really why those are the two top priorities.

When you look to share repurchases, to be sure, that increases the enterprise value of the company. The problem with share repurchases is they're more near-term and it's hard to be exactly efficient on when you do those share repurchases both from the company standpoint to correctly identify what the company's value is, you need to understand both the numerator, which is the challenge for us, because we have a number of different segments that really contribute to that numerator value through legacy assets that we purchased, right? These assets that we purchased are some in our water case more than 30 years ago. And so when we're seeing posting these fantasies and the high margins that we get on that, it's hard to project that out. The denominator clearly easy to understand and that's clearly one where share repurchase has a direct tangible value on how that impacts the value the shareholders.

So we continue to look at both of those consistently and we continue to evaluate those opportunities. All things being equal, bolstering, understanding of the numerator value of the company continues to be our current focus, to the extent that our cash position continues to grow and exceed the need for what we have on a period-over-period basis then the market still doesn't appreciate the share value, then that's something that we can take a strong look at and see if we can increase the value of the company through share repurchase or as our continuing recurring revenue growth through a dividend opportunity. So, with those…

Q: Okay. Yeah. No…

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
That's my thoughts.

Q: I think you made a lot of good points there on just the back and forth in terms of what goes into all that, and overall, you guys have done a very good job of kind of seeing this through and really nurturing in the infancy of these things, they're very obviously risky. I mean, that's the reason you got the Sky Ranch in the first place is because they're not managed properly in the beginning phases, a lot of bad things can happen. But I also think as we've progressed, if you look at the valuation the markets assigning, we're trading at like a 20% or 30% discount to where we were barely heading into Phase 1.

And as you touched on, there's been significant value created and I think it's just something to look at, because obviously, you can't stop developing lot, because, hey, we're just going to buy back stock, that's obviously counterproductive. But at the same time, the same way, you guys just picked up a small tuck-in acquisition of a couple of million dollars, having an open authorization there, which doesn't even cost the company anything, I think, is something worth consider, and, again, it's free. And it's really just an option to say, hey, we reserve the right if the market gets stupid enough to go in there and a couple of million dollars a quarter even, I think, is not something that's going to jeopardize the operation.

So, I think, again, I would just stress that something for and I think the Board should consider, it costs nothing to have an authorization and it just gives the company another option at its disposal. But, overall, I think everybody should be very pleased with where this is headed. What you guys have done and just all the thought that goes into this stuff. It's certainly not simple. So I was hoping to get out there for the Investor Day. I am not. But I wish you guys the best and just keep up the good work and we're looking forward to this, obviously. Thank you.

Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation
Well, thank you, and you bring up some good points there. So, it is – I feel fortunate that we've got a great management team with Kevin and Dirk and our engineers, and Serena as our controller. I mean, we just have terrific leadership here. But we also have outstanding talent, far better than I deserve or we all deserve at the Board level. And so these are weighty subjects that that we do take seriously and we do debate and you would be impressed with the dialogue at the Board level. While it doesn't seem like you see that tangible results of the debates and the thoughtfulness that go into those, I assure you that our Board is just terrific and deliberative about each and every one of those and the capital allocation strategies that we approach. So continue to monitor that. We will continue to evaluate some of those opportunities and continue to add to the toolbox.

And what I'll do is, I'll go ahead and start to close this. And for those that are either at a technology issue that didn't get to ring in or if something comes up that you didn't think of on the call, don't hesitate, give us a call. And for those of you that will be out here tomorrow for our Investor Day or those of you that are ringing in through the Q&A, we'll have a bit of a Q&A in that, so there's an opportunity for us to see, send out a team's invite for folks. So if you do have an interest in that, just send us an RSVP, and then we'll send you a team's link for the Q&A on the Investor Day as well.

So, with that, I'll ring off and hope you all have a continued relaxing and productive summer.

Operator
Thank you, ladies and gentlemen. This does conclude today's conference call. You may disconnect your phone lines at this time and have a wonderful day. Thank you for your participation.