Transcript of
Pure Cycle Corporation
Second Quarter Conference Call
April 12, 2022

Participants

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

Operator

Good day, ladies and gentlemen, and welcome to the Pure Cycle Corporation Second Quarter 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, Mark Harding, President and CEO. Sir, the floor is yours.

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

Thank you. Good morning. And I'd like to welcome you all to our second quarter of our fiscal year 2022 earnings call. We do have a deck for this presentation, which you can find on our website. So if you go to purecyclewater.com and on the investor page -- oh, right on the front page there, it'll tell you -- an icon in there that says click to join, if you can join on that. I'll be able to direct the slides to walk you through the presentation but that'll give you kind of a little bit more tangible view of the earnings call as a whole.

With me today, you all hear my voice a lot and so what I'd like to do is actually bring in some other voices to the call today and the folks within the organization that make things happen. We've got a very deep bench with some very talented folks here in the company. And so as part of the update to our land development activities, you'll be hearing from a Vice President of Land Development Activities, Dirk Lashnits, and he's got over 25 years of experience on land development activities, a tremendous amount of experience with some of the major homebuilders, some of them are direct partners and Sky Ranch. You'll also be hearing from our CFO, Kevin McNeill, and he'll be giving you an update on the financial results of the company.

What I'd like to do is give you -- for those of you who are new to the company, just provide a high level overview of kind of the land development and water and single family rental business aspects of it. For those who are more familiar with the company really highlight some of our tremendous accomplishments and really give you some color as to the areas that the company is performing on, and really how these legacy assets are starting to generate significant shareholder value.

So with that, I will start our presentation, move to the first slide, hopefully. I'll get a little technical. Now, there we go. Okay, so our first slide always is to get the lawyers out of the room. So this is our Safe Harbor statement that statements that are not historical facts contained or incorporated by reference in this presentation are forward-looking statements. I think you all are familiar with forward-looking statements.

So with that we really operate in kind of three business segments, we're reporting in two business segments, but really have these tremendous assets that are driving value for our stakeholders, investments in land and water investments, and then also in housing. Just could not be more true today than it ever has been and when you take a look at this portfolio of assets, we have about 780 acres remaining in our land portfolio. We originally started out with about 930 acres of land. We have water assets that include water rights in a water shortage area, it includes a tremendous amount of assets that we developed to continue to treat, transmit, deliver that water to our customers, collect that water back from our customers, treat that water, and reuse that water supply. And then more recently, we've entered into the single family home rental market on lots that we are actually developing and delivering to home builders. We're keeping some of those blocks for ourselves and being able to deliver rental homes on there, so that we can maintain that portfolio, continue to grow our asset value, and also continue to grow our income on how we get these multiple year revenue streams.

So with that, let me talk a little bit about our water segment. We own water in a water short region much of there's been a lot of attention to the scarcity value of water out west and we were particularly early on acquiring much of these assets. We've held them for more than 30 years. They have continued to appreciate in value. And as opposed to buying something having that increase in value in selling that our real business model here is that we're developing a utility function with that so what we do is we develop on a cradle to grave approach all the wells, the treatment, the distribution that takes that to the customer. We get two different fee instruments for that, we get a large upfront capital fee called a tap fee or a connection fee. Those fees are a combined water and wastewater tap fees, which are about $33,000. Customers are using that water supply, they're taking it, they use it in the house, they use it for irrigating outside the house, we get that water back through a collection system. We treat that water through a state of the art water reclamation facility and then we reuse that water supply for irrigation demand. So we've got dual distribution systems within our community where we're distributing that water back out to our irrigation demands and then also use that for irrigation -- or I'm sorry, industrial water for oil and gas purposes.

So our assets continue to grow in value. We're investing into that infrastructure. We're expanding our service capabilities each year to add value to the assets and their ability to generate revenues. And that's a whole network of investments whether that's going to be wells, pipeline, transmission pipeline, storage facilities, where we have both raw water storage and finished water storage, water reclamation facilities, water treatment facilities, just to make sure that this ongoing service of water and wastewater service to our community and our customers continues to add value to the company.

Customer growth continues to grow. So we have customers that are growing both within our service area as well as outside our service area. So our connections are getting very close to about 1000 connections, about 970 some connections and that continues to grow monthly, both through the service areas that we have at Sky Ranch as well as our Wild Pointe service area. And then we'll talk a little bit later about the opportunities on our large service at the Lowry Ranch that's on really the edge of the Denver metropolitan area. Moving on to other customers, so in addition to doing the domestic side of the business, we do provide water for oil and gas concerns. Colorado has a shale oil deposit play, which is continuing to grow, and this year has seen very favorable improvements in our industrial water user sales, so our oil and gas interests have hit record water deliveries for us this year. So we're very excited to continue to meet that demand, likely to see a positive continuing trend with the strong oil pricing. And as oil remains in 90 -- upper 90 range that certainly enhances the opportunity for oil and gas concerns to continue to develop that asset.

Let's talk a little bit about the large service area that we have. One of the things that's very attractive to the company is that we have a 24,000 acre service area which is one of the largest contiguous parcels of property next to an urbanized area in the country. And this asset is owned in trust for the state's public education system, so it's owned by the Colorado State Land Board, which really manages their assets as a fiduciary for public K through 12 public education in the state of Colorado. This is kind of an illustration that gives you a shot of really where our service area positions itself to the Denver Metropolitan Area. We've got growth that has really grown out to roughly three sides, three borders of the property. So it's a very attractive parcel of property. The state landlord is reviewing what they would like to do with the property. I think they have a very multifaceted, multi-generational mindset of how they manage your assets and take a look at it not only for how it generates revenue and a consistent income over time, but also how we can have opportunities for open space and recreation and then also taking a look at what that might generate for the public education system. So it is a very highly attractive piece of property and, as you can see, well positioned for the future economic growth.

So with that, I think I'd like to turn the floor over to Dirk Lashnits -- I'll go ahead and advance the slide -- all right, to give you an update on land.

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

Good morning, everyone. I'm Dirk Lashnits. I'm the Vice President of Land Development. I have been at Pure Cycle here for about five years with the onset of Sky Ranch. And, as Mark mentioned, I've been doing development in the Front Range, Colorado for last couple of decades. Worked on a lot of big projects around town. You may have heard of Highlands Ranch or Stapleton and the 930 acre site here at Sky Ranch is considered a pretty large development in the overall market area. So, on the slide here, developing 930 acres of Sky Ranch, 3200 residential lots, kind of tie in back to land development, kind of our vertical integration of our water assets, we're developing our new water customers. So, on the previous slide, we saw some assets, 60,000 SFEs of water available and this would be about -- this would equate to about 3200 of those SFEs basically. One lot equals one SFE roughly, so an average house. And you also saw the 29,500 acre feet of water that -- how that translates to our usage out of Sky Ranch. Sky Ranch also has a large commercial parcel that has great frontage on the I-70 corridor, the major east west thoroughfare through the metro area. And then our project is located on the east side of Denver, about a 20 minute drive into town.

All right, so, picture on the screen is our first phase. This is a 509 lot. We sold off, transferred all 509 of them. We have -- 505 of those were sold to our builder partners that are shown on the screen there, that's KB, Taylor Morrison, and Richmond. And then we've retained four lots and are doing that for our build to rent segment. Three of those have been completed in our -- have tenants and are rented out. And then we're in the process of completing the fourth lot. So 405 occupied houses, those are our current water customers, they bought taps, they're using our water and we sold 500 of our 505 taps. And we should be built out of this phase here in the next couple of months. Some of these numbers, we've received 10.5 million of reimbursable. That was a bond offering done a year or two ago. We've got pretty favorable terms on that deal. That 22.7 million in receivables, those are on the books for us to recoup those costs in future revenues from taxes come in. And that also includes our project management fees, so as a -- it appears like it also functions as the project manager for our metro district, which ties back to the reimbursable monies that are used to build public infrastructure that is reimbursable. The 36.7 million in lots' revenue to date, that's the sale of our lots to our builders. And then the 15.1 billion in tap fees to the Rangeview District.

Okay, this is a little drone footage of our project working from west to east here that just kind of flipped from the screen previous but at the bottom of the screen the video that's the rest of the site to build out, you see some foundations there coming along that street. That's the last of the houses to be built. That's in Richmond area. And as it moves to the end of the street there, right on that corner is our last BTR locked for this phase that would be for rentals in this neighborhood.

We'll go on to our second phase. So, the first day of the 500 lots, this phase is roughly 850 lots out of the 3200 we mentioned previously. So you'd seed all the different colors on this map, each of those colors represents a different builder partner. Those four builders, we have one carryover from phase one as KB Home. And then we are introducing new product lines and segments from the other three builders, DR Horton, Lennar, and Challenger. The second phase is subdivided into four different quadrants; the first one of those sub phases is highlighted in yellow there. So that's the area that's currently under construction, 229 lots in there. We're expecting to deliver those this spring. We've actually turned over a few of those lots to start the construction of model homes. If you were to drive out on site today, it's the model home vertical from KB Home and then the other three builders have started some foundations and we're starting to install the streets in this sub phase.

So we'll quickly go into some drone footage on this. Site here, again, kind of working from the bottom of the screen up from last screen we -- there's our new streets that have been installed on the bottom of the screen, and that is our school site. We have a charter school coming into the community. And then turn in and this quarter is going to be a future recreation center and amenity center for the neighborhood, so construction underway in there. Let's see.

The top of the map there is the school site is shown and then if you were to continue up the page, it is north that would be where our commercial property is, parcel is. And that's the 2 million square feet of commercial, that will start to come online as more rooftops develop out there than just a couple of numbers on this space. 70 million in lot sales, tap fees of 20.9 million, 61 million in reimbursable costs for that public infrastructure through the district. And then the $73 million in total development costs to bring during the second phase online.

So I think I'm going to turn it over to Kevin now to get into numbers.

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

Yep. Thanks, Dirk. So Kevin McNeil, CFO been back for a couple of years now. So this slide that's up right here shows how this phases of Sky Ranch developed. Three of the contracts that we have with the builders are under milestone payments, which means we get paid along the way as we complete certain things like utilities, streets and roads and all that. So this really summarizes what we're doing in the four phases. As Dirk noted, the second phase is broken into four distinct phases that we're developing one at a time and may overlap them here and then -- as it's coming up on the market. But this really shows a breakdown of the revenue, lot revenue, tap revenue and reimbursables by those four separate phases, and how they roll through.

The second phase is progressing nicely, we're about 57% done in the first sub phase. Now the next slide will show where we're at in this current sub phase, which as Dirk noted was about to 219 loss sold to home builders 229 in total; 10 of those we're keeping for our single family rental division. And what they do is they take these down in pieces as we complete stuff, like I said on the last slide. So the first two takedowns are complete, which is planted lots and lots of lead utilities. And then the third one is coming up, which will be finished lots, which will be the three builders that are under a milestone payment. And then the fourth builder, which takes -- which is the Dr. Horton builder, they take finish lots, so they'll buy all their lots at one time, they don't make milestone payments, they did pay a premium for it. To have that because we obviously take a little more risk during the development stage.

And so you can see then the slides, the graph at the bottom really summarize what the different builders are building and what a lot types are, because in this phase, we have a lot more different products than just front loaded, standard detached homes. We got townhomes and we got paired homes and alley load homes. So this hopefully gives you a good summary of what the different builders are building out there.

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

I'd like to take it back and talk a little bit about some of the single family rental market. And one of the things that we took a look at was how we can continue to add value to the assets that we have. And to cover this a little bit, one of the options for us is, we, as the developer, are creating value in the community by what we're doing on the horizontal land, where we're doing a lot of the streets, curbs, gutters, but then also a lot of the amenities, so the parks, the landscaping, the trails, and really monetizing the overall product. And that's adding value to what it is that we're looking at out there. And so one of the things that we thought was that, as we continue to build that value, is there an opportunity for us to continue to grow the asset value as well as the income potential. And so we took a look at that single family rental market, and really, the dynamics of it are very compelling for us. There's a lot of big players that have entered this market, they're entering the market, by just buying homes out there, they're starting to get into the fact where they're looking to buy lots, and then build on those as well, so that they can vertically integrate that as well, but we like it because we're carrying forward a lot of the equity value that we have in the land itself, as well as the water utilities.

And so when we're bringing a new home on the market, we're building that on a lot that has tremendous value in it. And, how we parceled this out, I know a lot of you that are familiar with the company have asked how we can accelerate the single family market business? We're trying to pace that out so that each phase of what we're looking at pays for 100% of the cost of the vertical -- the horizontal development that we have, for what we're delivering to our home builder customers, but also what we're retaining for the company itself, so that we're really fully -- we've gotten full returns on all of that investment into the roads, curbs and gutters. And then we go vertical with that, and are using very, very attractive financing rates to be able to do that. We're out in the market using mortgage money to be able to leverage ourselves on the incremental cost going vertical. And oftentimes, we already see that -- we're seeing about a 70% loan to value in that just because of the tremendous equity value that we have.

We put the first three homes up, rented them within two weeks at the top end of the market. So we have tremendous demand for that and we don't have the only rental homes in the community. There're a lot of private folks that have bought homes out there that are also privately renting markets. We think we have certainly an advantage there just because we have a team of capable construction folks that are able to help with some of that development activity, whether that's on the outside landscaping areas, and they're also helpful in maintaining the properties because they're on site very efficient for us to be able to maintain those. So we like that segment, we like how we're growing at segments and making sure that we're keeping up and not overextending ourselves while at the same time capitalizing on the opportunity that that presents for us.

Taking a look some of the math on this really generates about 30 -- our first three homes that we have are right about the rental pro forma. We're getting on average about 28.50 for each of the three homes. So that's generating almost $34,000 in annual revenue to us and then when you take a look at sort of the operations and some of the taxes and interest expense on the debt service on that, that gives us about a $15,000, $16,000 margin on that. So not only is this asset appreciating, and we were seeing about a 4% or 5% appreciation of the overall home value in the market, but we're also generating free cash flow to that. So it's a great opportunity for us. Very excited about how this is rolling out and monetizing to us.

Kind of an illustration of this first three phases, they were all right together; very efficient for building those. We're not actually contracting that -- well, we're contracting but we're not actually building those. So we have a homebuilder partner that built these three, did a tremendous job for us, a group called Valiant, and they really were able to get these up on time and in budgets on the first three. We have them under contract for our fourth and are working with them on our next 10 so that we can be efficient about our delivering those and this gives you kind of a view of -- we had our financing cost of about 300 and -- call it $330,000. We did have a little bit of capitalized cost in there for our team to go ahead and do some of the landscaping out on the exterior side but this gives you kind of a view of how that appraisal and what the market value of these homes are. So we see them out in the mid five hundreds and that's really a testament to kind of the appreciation of the value of the community as a whole. So we continue to be very excited about this segment.

I'm going to turn this back over to Kevin and he'll talk a little bit about the details on the financial performance for the six month ended. So, over to you.

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

All right. Thanks, Mark. Now for the fun stuff, the numbers. So the top three graphs shows three of the obviously operating metrics that everybody looks at revenue, operating income, and net income. And what we're looking at is for the six months ended February 28, 2022, compared to the prior four years -- of the same periods, just to give you an idea of where we're trending. If you look at the revenue, obviously the 2020, the second quarter 2020, that's really where we started selling homes and most of the lots and taps in the first phase, so that's why that big jump in there. If you look at this year, over last year, the same -- the quarter-over-quarter, it looks like there's a slight decline. But last year had about 1.5 million in project management revenues that we recognized from prior years that at the time until last year, we didn't think they were collectible based on Sky Ranch just getting started and the metro district growing. Last year, we determined they weren't collectable, we recognized some project management fees that weren't recorded before. So that was about $1.5 million. So if you factor that out of last year's numbers, this year actually increased a bit by just over a million, which is really because phase two has come on board. We've had a tremendous quarter in terms of water revenue, which we'll talk about when a little further down the slide.

Operating income remained consistent or right around that $3 million mark. Again, last year was slightly impacted by that project management fee, so it hasn't increased. And then net income is the next big one and it looks like we did an amazing job last year and some things going on this year but really what it was, was the same thing as that project management fee. Last year, we recognized about 90 million in public -- reimbursable for public improvements. That again, we didn't think they were collectible or we couldn't prove their collectible until last year, when we had a tax basis and the houses were growing, assessed values were way up. And so we were able to recognize about $90 million last year of public improvements. So again, factor that out of last year and this year is pretty consistent, shows a slight growth as a matter of fact.

For looking at the bottom a little more detailed with three segments that we've ever reporting on. Water and wastewater continues to grow in terms of assets we have grown. One of the slides earlier showed about a 65% increase in our investment in water rights and water systems. That continues to go obviously some at Sky Ranch and some just in our general service area. One thing I will point out is this year and this is not a typo, we did deliver 137 million gallons during the second quarter, a big chunk of that 125 plus was for oil and gas operators in their drilling process, which is obviously a testament to the oil and gas prices and demand and continuing to go which is great for that water business. Land development, Dirk spoke a lot about that, so I'll just point out that the gross margins remain consistent. We're continuing to progress on our second development phase and hope to move into the next quad fairly soon.

Single Family Rentals, as Mark talked about, we got the three, they're all rented, all three are under non-cancelable for one year terms, and they pay monthly, they all seem very happy. We got the fourth one constructed now -- being constructed, the foundation is done. We expect that one to come on line probably at the same time next year as they did about October, November of next year -- 2022.

So next slide, the top three shows just sort of our last completed fiscal year, so I won't spend much time on them, it just shows you where we're at from year-over-year. Again last year had a tremendous impact to the P&L with that public improvements and project management fees being recognized.

Looking at the bottom, this is really where we spend a lot of our time and focus is this capital allocation and where we're looking at our priorities for the next years or five years. So if you look at our business segments, obviously the land water and wastewater and single family rentals continue executing in all three of those, continue to focus on them, operating those in cohesive manner. We don't try to operate them standalone. The land development adds to the water. The single family adds to land development water as well. So we see the all those growing fairly consistently with each other.

The next one over them, M&A growth, which there's always questions about this. We're constantly seeking new land deals, water deals, or land and water deals. We can do any of the three we don't. It doesn't have to be one or the other. We can add to any of our segments or all three. It's a high priority this year in the future as it has been for the last couple of years. And obviously, we remain focused on shareholder return. One of the big things with the single family rentals is that that recurring revenue, which we think helps with our with shareholder return. And then this year, we are going to focus on some our ESG reporting. We've hired an ESG specialist who's going to help us really focus in on how do we identify and report on what we're doing from an environmental and social standpoint and how we can get better at what we're doing. We do a tremendous job, obviously, as a water company, but we feel we could use some help reporting on it, so that'd be a focus for this year.

Looking at the consolidated balance sheets, this -- obviously we filed our Forms 10-Q last night, it went out after market closed, so you'll be able to access it on our website, as well as the SEC. So I won't spend a lot of time. There was a press release that went last night with some more details. You can see cash, obviously, has dropped from 20 million to 5 million, which all -- majority of that is land development, obviously, as we build infrastructure, we pay for the cab, the Sky Ranch Metro district will pay us back. So we do have the two receivables, the 60 million in long term and current. We are expecting to do some -- to get some funding in the next few months that will help pay some of that back. Continuing down, you can see our current assets -- current liabilities drop from 12.5 million to 4.3 million, big chunk of that was the tax payments. We made some income tax payments last year with the one negative, I guess, of the public improvement recognition was we had a nice tax bill from that but that will be recovered, obviously, when we get some bonding and some tax revenues paid in, so. Equity continues to grow, obviously, through net income. We did have some exit options exercised, and did our normal stock grant to our board of directors in January at the annual shareholders meeting.

The next one is the income statement, which I think I've pointed out some of the bigger items, you can see that last year, in that three months into column for 2021, you can see the 1.5 million project management fee about three quarters the way down in the revenue section along with the 19 million down in the reimbursement. But beyond that, if you look at the current year, you can see our commercial customer metered water usages up about a million dollars, which is that tremendous amount of frac water that we sold, that's where that runs through and so that was pretty productive.

And then you can see the lot sales have increased, which a lot of that is what we call percentage of completion method where we recognize revenue as we complete the project not necessarily based on when we get cash. So there's that and we can obviously answer questions about that later. You can see their earnings per share at the bottom. Really it looks somewhat wonky, but again it's because that $20 million from last year had a pretty big impact on earnings per share obviously, and this year we're trending well for our for our three months, it's fairly a good two quarters that we've completed fairly consistent around $0.06, $0.07 per share.

Next slide. So this is our leadership and Board of Directors obviously and for those who are long term shareholders you'll notice one name has been replaced, Epker resigned from the board and retired entirely. He's off doing other things, traveling, and I don't know why he didn't want to stay involved in water business a few more years but he was with us for some 17 years, I think. So he was a tremendous asset, obviously. So we added Wanda Abel this year in January, she was elected by the shareholders. She's been a long-term legal counsel to us, for a number of years, and graciously agreed to join our board. So we welcome Wanda and look forward to her long tenure with us as well.

Stock chart obviously showing some of the -- how the stock has performed in the volume throughout the last few months or the last year or so. And that -- so I think that wraps up our presentation and we will turn it back over to Kate to open it up for questions and answers.

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

Before I do that, Kate, let me close and really kind of accent a couple of things. One of the things we're really seeing continued execution and performance here and oftentimes to somebody new to the stock, you would look at this thing and say, well, how are they doing this? How is it that we can generate this kind of income off the asset base? And it's really because these are legacy assets that we've accumulated a number of years ago and they are very good assets. I mean, when you take a look at inflationary times, one of the things that you want to see is hard assets and this company is probably going to be as well-positioned in a hard asset play as you can get with land, water, which is one of the most sticky asset, sticky customers that you get, because you have to have that water, you're going to make sure that you continue to pay your water bills, and then also single family rental. And so we like each of those segments, we've got tremendous growth in each of those segments and so we're pleased to be able to really start to deliver shareholder performance.

And as you saw the continuing results, one of the things that we're pleased about is that we've got kind of this pattern of revenue recognition together with our development activities. Kevin was talking a little bit about how some of that started last year with the recognition of our reimbursable. And what we see with the reimbursable are, as we continue to add a set value, so the homes that get built there, we have the recoverability of that through property taxes and fees that homeowners are paying. So that's a tremendous opportunity for us to not only capitalize on how we deliver these locks to our home builders, the key thing is not only is the company doing well, on each of these lots, but so are our home builder customers doing well. They're getting a tremendous value in the appreciation of the lot when they're delivering their home value. And we're very pleased that they're doing well, we're doing well, and the community is doing well. And so this partnership of us together with national homebuilders is really executing very well. We have a great team behind us with Dirk and Kevin and the rest of the folks within the organization that keeps us going day to day and making sure that the company executes and stays focused on what it's doing.

So with that, we'll turn it back over to Kate and if you've got some questions, we can try and drill down on some of the specifics of what we're doing.

Operator

[Operator Instructions] Our first question today is coming from Elliot Knight at Knight Advisors. Your line is live he may begin.

Q: Good morning, Mark.

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

Good morning, Elliot.

Q: Inflation is much in the news. Would you talk a little bit about how rates are being set for cap fees and monthly rates? What's the process? What do you think the outlook is for increases from here on to protect against inflation? That's question one. And question two is would you give us an update of the status of the two reservoir sites that Pure Cycle controls? Thanks.

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

Okay. Sure. So, rates and charges for water, and we have kind of two sets of charges there. We have the capital fee, which are tap fees, which are connection charges, those are paid by the homebuilders, they're paid at the time of building permit, and they're very large fees. You take a look at $32,000. That's a big chunk of capital that really pays for us to developing our system. And the nice part about these assets are that we've been able to stay ahead of the infrastructure on this, so a lot of investment has been made into that system to be able to keep us delivering that water and without any debt. And if you look at why we do what we do, and how we do it so well is because we do not have debt and we're able to invest in those systems incrementally. We've been very disciplined about that.

Tap fees are set -- really, we have we have two mechanisms for setting those tap fees. In our service area, those are governed by our agreement with the state of Colorado, and those have to be an average of surrounding water provider. So we take a look at where those water providers are developing their tap fees and the cost of the developing and delivering and bringing that water to their customer base. And as you might imagine, all of the close-in water here in the state of Colorado has been developed, it's been developed years ago. And each incremental development has to reach farther and farther out for water supplies and that's typically going to be reflected in the tap fees. And so when we set our rates and charges comparable to those entities that really does translate into the incremental costs of developing those water supplies.

When we take a look at that, at Sky Ranch, we really look to be competitive in the market as well, so we look at our nearest competitor. With the city of Aurora, we want to make sure that we're in line, slightly less than the city of Aurora to continue to provide a competitive advantage for our homebuilder customers. And much of our home builders that are building in Sky Ranch are also building in the city of Aurora. And they're seeing significant value building in Sky Ranch as compared to city of Aurora because the cost differential.

The rates, the monthly rates for our customers, those are really governed as well by typical water providers that are doing the same thing, so we keep track of that. What you'll see is you'll see much more pressure in the tap fees than you'll see in the rate per k-gal or the monthly rates, and that's really going to be ascribed to the scarcity value, the incremental cost of developing those water supplies. So, while you might see more inflationary increases in the rates as you look at the monthly rates, you'll see probably a bit more pricing leverage or pricing advantages in the tap fee just because of the incremental and the higher cost of doing that.

Your second question was how do we look at home values -- what was it?

Q: The reservoirs.

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

The reservoirs, that's right; an update on the reservoirs. So, we have two very significant assets in these reservoirs and really those are embedded value within the water utility itself. And Colorado is unique because not only do we not get very much precipitation on an annual basis, when we do get it, we get it very quickly, right. Mother Nature does a great job of storing that water for us all winter long but we get it over a six-week period in the spring, in the spring melt. And the challenge for us here in managing the supply versus the demand is that supply is available to us far ahead of when our demand comes in. And so, being able to store that is a very unique opportunity. And these are two reservoirs that are what we call non-jurisdictional reservoirs. That’s a bit of an inside baseball talk about how you look at the time line and the permitting needs for getting those reservoirs built.

We have interest from neighboring water providers and regional water providers to be able to participate in those developments, and we continue to explore those. I would say, there’s nothing that I can point to tangibly on the scale other than we continue to work with our partners at the South Metro with the WISE system, which is what we have a portion of our water supply and developing those assets as conjunction with all of the other elements that the partners are working on, on other water supplies and treatment systems and water quality systems as well as our neighboring providers in the Denver area. So, it continues to be a significant asset for us. We continue to explore not only how we’re going to use that for our own purposes, but for regional purposes.

Q: Okay. Going back to the tap fee though, do you see tap fees going up this year?

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

They will go up. We do notice our customers, there’ll probably be -- I think we’re looking at -- we’ve built in a tap fee increase of around 2.5%, a couple -- I think a year ago, so we had that incrementally in there. I think we’ve seen a higher appreciation in our surrounding water providers growth to that but what we look to do is we continue to increase those so that we don’t have this very, very large increases followed by flat level increase. We want to keep that kind of increasing year-over-year.

Q: Okay. Thank you.

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

You bet.

Operator

[Operator Instructions] Our next question today is coming from Bill Cunningham with Seeking Alpha. Your line is live, you may begin.

Q: Hi, Mark. How are you?

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

Hi, Bill. Great. Thanks. How are you?

Q: Good. Yeah. So yeah, I’m a private investor, but I do write occasionally for Seeking Alpha. So, that description might have not been 100% perfect. In any case, your earnings this quarter were okay but if somebody is looking at the number, they’re not going to be blown away by it. But I think what might not be recognized, and correct me if I’m wrong, is that you’re kind of in a trough now where Phase 1 has basically been almost done and Phase 2 is just about to ramp up. So, the GAAP numbers don't really fully reflect where you are right now.

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

That's a fair statement and one of the things that I think is important to highlight is that we have a number of options in generating revenues to the company. And we do have some seasonality in delivering lots in the land development business. We do have kind of weather in Colorado that prohibits a lot of the outdoor activity. We do develop, we do construct year-round, but it's very difficult for us to get some of that pavement and concrete down in the winter months. And so, we were very fortuitous in getting all of the, sort of, the utilities and all the dirt work done in the winter time frame, both coming right up to the spring deliveries. And as you saw in that drone footage of kind of the aerial of Phase 2, we've got a number of roads and alleyways done now, so you're going to see tremendous activity. We still feel that we're on pace to deliver all 229 lots. So, when you take a look at how those numbers are going to roll in, they do roll in more towards that finished lot phase with that lot delivery.

We have two types of contracts. We have the incremental payment contract with three of our builders and then the finished lot delivery with one of our builders, and it really optimizes how we're able to cash flow some of that stuff. And quarter-over-quarter, you might see us invest a bit more in our construction in process, but year-over-year, you're going to see that continued growth. So yes, we had great revenue from oil and gas opportunities, while we were working through the winter months and positioning ourselves for a lot of the finished lot deliveries in the spring and summer. So, you will see that acceleration in Q3 and Q4.

Q: Yes. Well, I even know with your projections even from last quarter, you were showing that kind of the revenue from the lot sales as you were finishing lots, were going to be relatively low now, and you've got a kind of a bigger number for a couple of quarters away, which is even your current slide show that. So, this shouldn't be a surprise to anyone, but.

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

No, very predictable. You're right, and, really, the important part is one of the things that give us the flexibility of doing this is the liquidity of the company, that we have a great cash position, that we have the ability to invest in those executions of the business lines and making sure that we can capitalize on efficiencies in delivering that. And so that's why you see a little bit more investment in the winter months and then a little bit more returns as we roll into the spring and summer deliveries.

Q: Sure. And then also, I guess anybody who's been a long-term investor of Pure Cycle knows you have a lot of assets that have not yet been monetized. I know some of your short-term investors would like you to monetize them immediately. Even some of your longer-term investors would like you to monetize them sooner rather than later. But, to the extent they're not being monetized or sold, they're also increasing in value, I believe. And as we were listening to the conference call, I think the last year's CPI number was 8-plus-percent. You've got land assets that you haven't monetized yet. You've got the water rights you haven't monetized. And even though you haven't monetized the map, they're basically increasing great inflation hedge, I think every year.

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

Yeah. The challenge, when you take a look at this is that we do have these tremendous value assets that are recorded at the book value. And so, a lot of times, when you see us posting up these great returns, when we sell an asset, it's hard to see the predictability of that on a quarter-over-quarter or year-over-year basis because until you actually do that and print that sale, you can't recognize that revenue.

Q: Right.

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

But then, that makes a question for folks, when they say, well, how is it that the company is going to generate that kind of returns off of this what we would show on the balance sheet is a relatively modest asset, was just because the cost basis that we have and the time that we've accumulated those and continue to develop those assets.

Q: And finally, can you go through what the status is with the models being built in Phase 2, and what's happening there? You haven't really mentioned much about that.

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

Yes. So, we've got four builders, each of the builders have three model home permits where they can do field construction. I'd say, KB was the most aggressive getting out there prior to some of the roads being finished. And so, they were out there that we do have a model home up for KB. We've got foundations being started for the other three builders. I think model homes for most of the builders, they're looking at a thing -- look, we just want to get in production. We want as many building permits as we can get as fast as we can get them. And really, that's a testament to the strength of the housing market here in Denver. While you can see and the press really continues to report the price appreciation of average home values here in Denver continue to grow, and it's expensive. And the thing that we like is that we're kind of an entry-level product basis and it's hard for me to say that a $400,000 home is an entry-level home. But when you compare that to the average home value getting close to $700,000, we are ideally positioned for continuing to develop these because there's not a lot of that product in the market. So each of our homebuilders really are looking to pull the stops out and get as many permits that they can as fast as they can.

And really, now that we've got all our roads up and access and fire access and everything completed to that, it's really just processing. So I know each of them have got not only their model permit in, but also starting to get their production home permits in. So, you're going to see a tremendous amount of activity, which brings me to another thing that I wanted to mention is to let you all know that we will have an Investor Day this July. It will probably be just after the 4th of July. So, look for an opportunity for us to send that out into the market here in the next month or so. And if you can join us, you're going to see a tremendous amount of activity on the site. It gives you really a tangible view of not only how we're executing, but also how each of the components of this fit together, how the water fits together with the land development fits together with the single-family rental.

Q: Great. Thank you, Mark. And I have attended most of your Investor Days, they're always extremely informative. So, anybody who has any inclination to go, should.

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

Yes. I appreciate that. They are. It's very helpful to kick the tires.

Operator

Thank you. Our next question today is coming from Geoffrey Scott at Scott Asset Management. Your line is live, you may begin.

Q: Good morning, Mark. How are you?

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

I am great, Geoff. How are you?

Q: Very well, thank you. Two questions. One, you haven't talked at all about the commercial activity and then the commercial possibilities going forward. What is the timing for it and how has your outlook changed over the last three months? And then the second question has to do with the rise in interest rates and the future rise in interest rates. And are you expecting any slowdown at all in builder activity or visits to builder by potential purchasers and how increased interest rates may impact future bond sales? Okay. Thanks.

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

Great. Great questions. So, let me take the second one first; interest rates. We do see a rising interest rate market and it's sensitive to housing. That mortgage rate is a very sensitive component of it. I think that our positioning at the starter home market gives us the most flexibility. Not only is that a great asset in terms of what entry-level buyer is, but it also because of our positioning and our cost basis in this, we're substantially less than our competitors in the city of Aurora. So, that's our next closest master plan community and many of our homebuilders are building in that community, which is less than a quarter of a mile away from us, and they're building the same model homes that they're building at Sky Ranch or same home product that they're building at Sky Ranch for $50,000, $60,000 cheaper. And so, when you have that dynamic where we're so competitively advantaged in there, what we're likely to see is a lot of those buyers really are going to gravitate to our product or our development as opposed to other developments because it's more affordable for them.

If you're in the middle market where those homes are $600,000, that interest rate sensitivity is super, super sensitive. And so, as opposed to an entry-level buyer or a move-up buyer, they're going to find that same buyer capacity even in a slightly higher interest rate environment. Interest rates do increase the overall cost. And so, are we seeing increased costs in developing our horizontal work? We are. But the advantage for us and how we're delivering this is a large portion of us delivering this infrastructure really is through reimbursables and our actual cost in doing that get reimbursed by the bonding capacity and the recoverability of that. Now, we do see higher interest rates in the bond market, but that's going to be offset by what we're seeing as higher assessed values in the homes. And so, I think what we're seeing -- we may have a few basis points increase in the interest rate, but I think we're seeing 6%, 7%, 8% increases in the home values. And so that capacity more than offsets what we're seeing is a bit of an increase in the interest rates for the debt market on the municipal bonds.

On the commercial opportunities, we continue to reach out to a number of commercial operators. I think the most attractive opportunities are going to be in the light industrial side, where we can put up some sort of distribution centers, and we've got a portion of the property that's kind of set aside for that. There might be -- as you get -- those users really like the interchange issues, they like our proximity to the airport area and they bring a tremendous assess value. And we've talked about that in the past, where our commercial really Colorado is a sales tax incentive state and so, the commercial properties pay nearly four times the tax assessment that the residential property does and so that continues to enhance our bonding capacity on the commercial side.

A lot of the retail and kind of the box store stuff is still a bit early, but we continue to work on the master plan and the transportation network for that to make sure that that's going to be consistent. We've got work with CDOT on the interchange to make sure that that aligns with how our commercial opportunities are. And so there's three elements, really four elements of the commercial, you have retail, commercial, light industrial and then that fourth being multifamily, and we use that multifamily to be a transition between the commercial and residential and so, all 4 of those continue to inch forward. I would say multifamily and light industrial probably will occur before retail and commercial.

Q: Okay. Thanks very much Mark. See you in July.

<u>Mark Harding - President and Chief Executive Officer, Pure Cycle Corporation</u>

Look forward to it.

<u>Operator</u>

Thank you. Our next question is coming from Greg Sterling, a private investor. Your line is live, you may begin.

Q: Yeah. Hi. Good morning, guys. Most of my questions have been answered, but I was just wondering about your outlook for fracing water sales for the balance of this year and going into next?

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

Good question. Certainly had a robust demand in the first half of the year. As we take a look at the second half of the year, oil being $90 plus certainly is an advantage in that. I know operators and we've got probably three or four operators in this field are really working on permits and kind of rig availability. And so, it's going to be a function of how quickly they can get all of those elements together. We've got more fracs coming up this -- in the next 60 days. I think we've got another four well pad fracs. And the fracs are actually interesting because they're increasing in their designs as well. So, as they continue to develop the shale oil play, they continue to fine-tune how the frac design works and they're using more water per frac on each iteration of that and so, we see that kind of ticking up. It's hard to say -- I hesitate to give a lot of guidance in that.

You're going to see fiscal year record revenue in frac revenue and then how we roll into next year is going to be a function of the permits and the continued strength in the market, and both of those look very good. We see not only permits in all of the areas around Sky Ranch, but to give you a heads up, we do have, I think, around 10 wells that are being permitted on Sky Ranch itself. So, we'll likely see those get drilled in probably not in late '22, but early '23, I think, is when they're scheduled and not only will that generate frac revenue for us, but that will generate oil royalty revenue for us; and that's a nice opportunity. We don't highlight that often enough that we do have mineral estate on this. We have minerals states at Sky Ranch and then we have other minerals in the southeast part of the state, so we continue to monetize that asset as well. And we look for that to correlate with the price of oil. So, you can -- as we get a little bit more of guidance in terms of rig count and things like that, we'll certainly pass that along to you all.

Q: Great. Thank you.

Operator

[Operator Instructions] Our next question is coming from Tucker Andersen with Above All Advisors. Your line is live, you may begin.

Q: Good morning, Mark.

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

Tucker, it is great to hear from you.

Q: Good to hear from you and if I can take a moment of personal privilege, good to hear from Elliot Knight, too. I should now work with friends forever, coworkers. I apologize. I missed a few minutes of the call, so if you covered what I'm going to ask, just tell me and I'll go back and listen to the replay. But my question involves both, inflation and labor shortages. And are any of them affecting either your subs on the work they're doing for you in terms of development or more likely your builders? Because I know there are a lot of builders who have really had to delay deliveries because of either labor shortages or supply chain issues and stuff like that and they can't get refrigerators one week and they can't get something else next week. And so, I'm just sort of curious about what you're seeing in the Denver area?

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

Great question. And it is an issue that I think has been managed fairly well amongst our -- not only the major national homebuilders, but also our local builder that's delivering the BTRs. I think the national folks have the ability to flex their labor pool or their contractors from one project to another, and they're doing that based on efficiencies and where they get the most permit and they can line built. So, we have not seen that really impact the delivery of homes out here.

And in our BTR segment, one of the things that we were doing is working with our builder on that and saying, listen, we've got these that are coming down the pike, and we do want to manage the supply chain issues, and we have some flexibility to inventory some of that stuff at our office. And so we've got some warehouse space here and we've given them the green light to go ahead and preorder some of that stuff. And if that stuff comes in early, great, we can warehouse it. And if it doesn't, that we have the ability to kind of manage inventory to deliver those to make sure that we're really not constrained by either the supply chain issues or labor shortage issues that we want to make sure that there's some fore planning in that.

On the inflationary side, talking a little bit about that, we do think that that we will see some cost increases on delivering some of our horizontal infrastructure. But because that's reimbursable, we talked about this a little bit earlier, but we do get a real direct recovery on that. So, that's not going to impact our margins, and that's pretty unique. We're in a position that we do know that inflation will impact some of that costing but because we have that relationship to be able to deliver that and we get our actual costs back on that, that's a recoverable increase to us that really doesn't impact our builders either. And so, that's important component to them is that they're protecting their margins too and we're not having to pass that along. We see it, but we're not having to pass that along. That gets passed along more through a longer term recovery mechanism, which are going to be property taxes over a 30-year basis.

Q: Thanks. That's very helpful. Keep up the good work.

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

Well, I look forward to seeing you if you can make it out in July. Certainly [Multiple Speakers].

Q: I will do my best but I will visit my daughter at the same time, if I can't.

Operator

Thank you. Our next question today is coming from Greg Bennett [Phonetic], a private investor. Your line is live, you may begin.

Q: Good morning. I had two questions. One, the oil and gas business that you mentioned on Sky Ranch, are you in the oil and gas business? How do you structure those deals or those wells? Are you doing it through a partnership with somebody who knows something about oil and gas, or are you doing this on your own?

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

Neither. We really leased that out. So, we've got a -- we own the minerals, 640 acres of the 930 acres that we originally acquired with Sky Ranch, and then we leased that out to the oil and gas interest. And our original lease was, boy, it goes back, but it was originally leased out to Anadarko, which got assigned to Conoco, which got assigned, which got assigned. And so, it's now owned by a new public company called Civitas, which is a combination of a number of companies more recently. But we're just a mineral estate owner, and they go in and they develop the resource, and we just get a 20% gross royalty interest.

And while I'm on that, one of the things that we were very careful about when we did those leases is knowing that we have a master plan community. We were very specific about where those oil and gas sites were going to be. So, we have them located in an area that has some strong buffers against where that would be compared to residential areas to make sure that there's not a conflict between the residential development and the oil and gas development.

Q: And I take it that the homeowners, the new homeowners, it's disclosed that that can happen, so that there's no pushback from the homeowners?

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

It is. It is. And the setbacks are substantial because we incorporated a lot of kind of open space areas that buffer the oil and gas interest.

Q: The water that you're selling for oil and gas, is that on federally leased property, or is that on private property since the Biden administration seems to be pushing back on federal leases?

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

Yes. It is all private. There is some state interest on our service area, the 24,000 acres that we have as our service areas owned by the State of Colorado. They have leased those oil rights as well but for the most part, it's all private interest, private property.

Q: Okay. I think this is my final question. 1031 exchanges for property you're a taxpaying company now. Is that correct?

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

We are.

Q: Is there a way that you could structure maybe the commercial property development to be done through a 1031 exchange that you maintain those properties and then create evergreen income on the rental from those properties?

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

We are looking at that. We have some very significant talent on our Board that can help us with some of the commercial opportunities. We've got a gentleman by the name of Jeff Sheets, who really spent 30 years of his career managing commercial properties for one of the largest commercial developers here in Denver area and looking at some of those very transactions where we can stay in. The prevailing thinking on our commercial and I'll give you both management as well as our Board's directive is just because of the liquidity that the company has, it affords us an opportunity that we don't have to chase land sales.

Land sales on the residential side are appropriate because you've got a residential unit. But, when we're looking at commercial, we're looking at staying in the deal a little bit longer, we may not be choosing to do the vertical side of it or the management side of it, but there are opportunities for us to stay in that land deal on a number of transaction structures that allow us not only to optimize the land value and the increase in value from developing that commercial opportunity as well as bringing that commercial on line sooner. If we can bring that on line sooner for an operator, they can invest more in the vertical construction side of it, and then we can form some tax advantage strategies associated with that.

Q: So, are commercial ground leases, is that something that happens in Colorado where somebody would do the vertical and you would do a ground lease for the property and then there would be no tax gain to the company, just evergreen income?

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

Yes. That's right. That's exactly what we're looking at.

Q: At what point do you think the commercial -- you need a certain population, I guess, out there. When might the commercial for a grocery store tenant or whatever, when might that -- what year might that come about, do you think?

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

Good question. We have had a number of conversations with the local -- well, with the national grocer here. The dominant market player here is Kroger. They operate through Kings, the King Soopers brand. Have had a number of conversations with them about what footprint they're looking for, what size store they would be looking for or what size structure they'd be looking for as well as sort of the demographics on that. And they all -- it used to be where they like to pull, and so they'd be early and then pull some of that. They like to be just a little bit later in that so that they can capitalize on a larger store in this area. So, I think the grocer is probably still a couple of years out, but we still have opportunities on the light industrial.

And then we're trying to balance out what type of retail component. We have a lot of pad sites that we can create for fast casual and the services, maybe some medical services where we get dental and urgent care facilities. We want to make sure that all of that kind of blends itself together. We've got the space for it. We've certainly got the access with the interstate there. And so, we want to make sure that all of that is really a continuing play. And we really do have kind of a good market share there. If you look at the site, the south side of the interstate really has the best potential on there. Typically, when you see it, both sides of the interstate create those commercial opportunities and the north side is a bit more challenged just spatially, right. They have the Union Pacific's got the mainline system that rolls through there, which kind of bifurcates it, which creates a little bit more challenge of developing that on the north side. So, we very much like our competitive advantage at the interstate there and the commercial play that we see on that.

Q: Is the exchange completely done on to the property, or does the state have to change the interstate -- the exchange to get on and off to your property?

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

There will need to be improvements to the interchange. And so, we've been working with CDOT in the county about the timing of those, the capacity of those and then how we've got some impact fees that will lay over for both the residential building permits as well as the commercial building permits that help fund all of that stuff.

Q: Okay. Thank you.

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

You bet. Thanks for the questions.

Operator

Thank you. We have no further questions in the queue at this time.

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

Terrific. Well, let me just close by thanking Kevin and Dirk for kind of weighing in on this thing and really give you all the opportunity to kind of hear from some of the true talent within the organization that are really executing the results on this. So, as some of the call information was, the results of the quarter were very impressive, but we're looking to have an even better close out on finishing up the balance of the year, so continue to look for that. And I really do encourage you if you have a chance to come out and visit in the summer, Colorado in the summer isn't a horrible place. It's our best season, even though I know a lot of you folks like the winter here in Colorado for our recreational opportunities. The summer really is beautiful out here, and you'll be able to see kind of the progress that we're making on all fronts of the business, on the water side, really get a chance to tour our state-of-the-art water reclamation facility, see how we're managing our oil and gas systems and delivery of raw water and reuse water to oil and gas operations, the delivery of our second phase, we'll have broken ground on the charter school aspect and then continuing development of our single-family rental. So, all of these really do continue to add tremendous value to our shareholders.

We continue to be mindful of how to communicate that to the public, so that that also has a direct correlation to the share price, which I think we all would agree that it could be significantly better, and we're going to continue to post results quarter-over-quarter, year-over-year, so that that continues to translate into the market as well.

So, with that, if you all didn't get a chance to answer questions, certainly give me a call, I'd be happy to drill down on any of the specifics. And we will hopefully see you all in the summer. Thanks very much.

Operator

Thank you. Ladies and gentlemen, this does conclude today's event. You may disconnect at this time, and have a wonderful day. We thank you for your participation.