Transcript of
Pure Cycle Corporation
Second Quarter 2017 Earnings Call
April 11, 2017

Participants

Mark Harding – Chief Executive Officer

Presentation

Operator
Good day, ladies and gentlemen, and welcome to the Pure Cycle Second Quarter 2017 Earnings Call. All lines have been placed on a listen-only mode, and the floor will be open for your questions and comments following the presentation. [Operator instructions.]

At this time, it is my pleasure to turn the floor over to your host, Mark Harding, CEO. Sir, the floor is yours.

Mark Harding – Chief Executive Officer
Thank you, thank you very much. I'd like to welcome you all to our mid-year earnings call. What we'd like to do today is highlight our results of operations for the first six months of the year. As with most of our calls, we do have a slide deck for this call that can be accessed on our website, so it'll be on the front page of our website, lower middle highlight bar where you can click on that. It'll pull up the presentation, and I will note the transition of the slides as I progress through the presentation.

With that, I'll go ahead and get started. Our first slide is the Safe Harbor statement. Statements that are not historical facts contained or incorporated by reference by this presentation are forward-looking statements pursuant to the Securities Exchange Act of 1933. I think you all are familiar with the Safe Harbor statement.

Just very quickly and I'll just quickly do this for those that are new to the company or new to the story here, Pure Cycle at its DNA is a water utility company. We have about 27,000 acre-feet of water resources in the water-short Denver metropolitan area that we use to generate revenue, both in terms of the water utility segment as well as some of the other segments that we have which I'll highlight in our presentation.

Some of those areas are that we provide water to single family communities, and then in addition to providing the utility franchise, we also happen to own some land that we're developing that I'll highlight a little bit more. We provide water service to the industrial community through oil and gas users, provide water for fracking purposes in the metropolitan area as well, as some royalty interests that we have from a mineral estate that we have.

Moving on to the next slide, we're sort of a cradle-to-grave water utility where we own the water supply. We develop those water supplies using that infrastructure that either diverts the water from a stream or from a well. We treat it, put it into a water distribution system, we collect that back from our customers as wastewater. We process that wastewater and then we reuse that wastewater through an irrigation system. How we generate revenue is attributable to that.

Our portfolio has the capacity to serve approximately 60,000 single family connections; that's our unit of measure which is the amount of water that typically serves a single family customer or about 0.4 acre-feet of water per year. We get revenues from two sources. One is an upfront capital fee where we get a one-time capital connection charge, which we define as our water or wastewater tap fees.

Our water tap fees are right around $25,000 a tap. Our sewer tap fees are right around $5,000 a tap, so combined water and sewer tap fees are around $30,000 per connection, and then we get your monthly revenue. So, you get your annual water and sewer revenues that you bill to your customers based on meter water usage, and that typically translates into about $1,500 per connection per year in our particular market.

With that, I'll move on to the next slide and talk a little bit about some of the activities that the company is involved in. We own some land in what we think is the right area, the metropolitan area, the Denver metropolitan area. This will be an aerial illustration. The red highlight outlines where our land interest is. We're right along the interstate. We have an interchange right at the entrance to our property. We're about four miles south of the Denver Airport. We're about 16 miles east of downtown Denver and really, we find ourselves in the largest concentration of economic activity in the metropolitan area. It's called the I-70 Corridor.

It has a very large employment base. You have some very significant projects that are under construction, one being the Gaylord Project, which is a very large hotel resort conference center facility that's currently under construction. That's set to open up sometime next year which will have significant employment, in excess of 2,000 employees, and then a very large distribution center that Amazon—you have the Amazon Distribution Center together with Prologis Park, which has other industrial distribution centers that are also very large employment centers that are really within two miles of our interchange.

Our target market for development, and this is really a mixed-use community that includes single family homes, multi-family homes, commercial, retail, and industrial uses, so it really positions ourselves very well. Our target for housing in this area is a starter home product. We're looking at the entry-level home opportunities with several different products within that entry-level home segment.

Moving on to the next slide, I'll give you a little bit more data on where this particular project is and some of the surrounding and neighboring residential developments. We're really within about a half a mile of some of the more active and probably one of the most active residential areas in the I-70 Corridor. We have zoning for up to 4,400 homes of a mixed type, where we'll have some single family detached, single family attached and multi-family homes.

We have about 1.35 million square feet of commercial which should add another 600 to 800 single family equivalent water connections to our system. And, if really you drill down on just this one asset, and this asset being kind of a real vertical integration, not only do we control the utility side of this, but we also control the land side. If you look at the utility value of, call it 5,000 single family connections, it's about $150 million in tap fee numbers, round numbers and then about $7.5 million annual revenue, year-over-year revenue, is attributable to the project.

If you move to the next slide, we'll talk a little bit about some of the infrastructure that we have going. We've been installing infrastructure to deliver our water supplies, which are about four miles south of the bulk of our water supplies. We have water beneath the property as well. But the bulk of our water portfolio is about four miles south of the property, so we've been extending about eight miles total of pipeline where we're connecting all of those supplies up to the property. We've been accomplishing that over the winter months. We have just completed the physical construction of that pipeline and then are looking at additional infrastructure.

Some of this is highlighted where we have a reuse system, that purple system, will be extending and bringing back our wastewater return flows back to a storage reservoir where we can meet our irrigation demands, as well as looping the water system and some of the roadway infrastructure that will bring access into the site. Ultimately, what we're looking at doing here is developing our first phase of the project.

We'll be developing finished lots and selling those finished lots to homebuilders in the metropolitan area and looking at targeting about 500 lots, 500 homes for this first phase. If you move to the next chart or the next slide, this'll really kind of highlight how this is likely to progress. Of the land entitlement for this particular phase, we have the full land entitlements, but then we're really getting into plats, preliminary plats and final plats for these first 500 units, working with multiple builders.

So, this is an illustration of a three-builder model where we have three separate builders who are working on various sizes of products where they're 45-foot lots, 50-foot lots and 60-foot lot products on this particular configuration and being able to deliver product and lots for multiple builders simultaneously with each builder likely having maybe two or three different series within that. You might have six or seven different price point series within this first phase with as many as three different builders working on it.

Currently, we are working on all the agreements that need to be in place to bring something like this to construction, and that includes lot takedown purchase agreements, tap purchase agreements, absorptions, specifics on how many lots we're delivering per quarter, per builder, per series. A lot of that activity has been going on for the last three months and we're making very good progress on that. I hope to have some clarity as to announce who we're working with, what the structure of those agreements are going to look like, the timing of those agreements, probably within the next, say 60 to 90 days.

Concurrently with that, we're working on engineering, permitting and the construction documents for that, so we're paralleling this track where we're getting all the detail that tells us exactly where all the infrastructure needs to go, where the roads go, where the utilities go in each of those roadways, where each of the curves go, all the alignments attributable to that. We're probably about 60 days from having construction documents available.

We can start taking that to the market and have most of that work bid out, so the company will bid that on a competitive bid process sometime later this summer and then, hopefully, look to deliver lots probably the first quarter of calendar year 2018. We're making extremely good progress on that. We will have some lot takedowns later this year with some home deliveries sometime first part of next year. We're very excited about the potential that this represents for the company.

We have been very encouraged by the demand for this particular product. I think there's a void of having this type of product in the metropolitan area. As many of you have heard me say from time to time, the metropolitan market, historically, has had about 50% of all new home permits qualify in this starter home market, historically, and I'll use a 20-year average as the historical segment for that. And, those statistics, just for a number of reasons, have really dropped down to less than 4%, so we feel very confident about what it is that we're bringing to market, the demand we've seen for that and in fact are emboldened so much by that, we're taking a look not only at this first phase and getting this first phase punched out, but taking a look at what we're doing for our next act.

If you take a look at the next slide, we'll really highlight the next phase of what it is that we're looking at, so we'll probably take a look at the next 480 acres of this particular project and that will be a combination of a significant amount of residential activity. The first phase is primarily detached single family lots and homes, and this one will be a combination of detached and some attached product as well as some commercial product because we have the interchange right there along the interstate and then a half a mile of frontage along the interstate. So, not only will this be a mixed use in the residential product, but it'll also be mixed use with some commercial, industrial, retail activity as well.

If you move to the next slide, we have some illustration of what some of that might look like on the commercial phase. We are a little bit farther ahead in our thinking on the commercial side of this, having focused most of the residential activity to the neighborhood that we're already working on and then seeing how that integrates with the next phase of the residential activity.

What we've also seen in terms of the demand for the residential product is a high demand for commercial activity, and that's primarily because of the uniqueness of the property's position along the interstate with existing zoning, with existing utilities, some available land where not a lot of that exists in the marketplace. We're excited about not only how this project unfolds from the residential perspective, but also from a commercial perspective.

Our likely scenario is to kind of open up that phase once we have all of the commitments from the builders locked in on the first phase, then we'll start to open up that second phase, really look at opportunities with our existing portfolio of builders as well as opportunities for other builders. We want to expand that out and make sure that not only do we have opportunities to continue to produce product for the people that are currently involved with us, but also continue to produce product for demand of other builders that may have other types of product categories.

Looking at the next slide, that'll kind of drill down into a higher view of Sky Ranch, our particular assets, our water system. We've really interconnected our water systems and supplies, not only that we can deliver what's now, effectively, buildout water supplies for Sky Ranch, but also continue to service our industrial customers in the oil and gas space to be able to parallel serving water for residential as well as commercial purposes.

I also want to talk about and highlight some of our other activities in addition to our organic growth activities, and I'll define development of Sky Ranch's organic growth initiatives. But we also have acquisition opportunities, and this year we acquired one of the opportunities that we've been evaluating for a bit of time. A little bit south of our existing service area at the Lowry Range, we acquired the service rights to something called the Wild Pointe Ranch. It's a rural type product where you have large lot development, custom home product that has central water and individual septic sewer for the residential, and then you have municipal sewer through the neighboring town, the town of Elizabeth, for the commercial parcel.

This particular system really fits nicely into our portfolio and represents some of all they key metrics that we look for when we look for acquisition targets. It has an existing customer base, so we add about 120 existing residential customers and probably 20, 25 commercial customers. It also has some expandability to it, so in addition to the 120 units, there's probably an additional 40 to 50 single family residential lots still under construction. I have home builders that have those lots that are working at bringing those lots online later this year and over the next three years.

We also have significant growth opportunities in the commercial corridor, so we think this grows to about 300 single family connections in total. We will participate in getting the tap fee revenue attributable to those, so there's probably another $2.5 million in combined water, tap fees from residential and commercial connections that ultimately grow to about $350,000 year-over-year revenue at the full build-out of the project.

We're generating about $140,000 in water revenues from the existing accounts, so it's a nice opportunity for us and really emphasizes the opportunity for us to expand our water resources and our operational footprint into other areas. Like that one, we have our nets out for other opportunities that are similar to Wild Pointe in the same geographic proximity. There are a number of systems that are in this area that also have opportunities for us to take a look at bringing value to it, not only as an operator, but also as water availability.

Let me move to the next slide. Our next slide will really kind of highlight some of our regional water projects that we're a participant with. We're in the WISE Water Project, which many of you have heard me talk about over the last several years, but we continue to progress on that. We are fully connected to the WISE system as are three other of the partners that we have in this particular project. All the remaining providers are continuing to add that infrastructure in and hopefully have that infrastructure sometime later this year.

We will have water available this summer. There are several things that are components of this system. We get about 500 acre-feet of additional water supply, so there is water that can come out of that system that will help boost our capacity to provide water to Sky Ranch as well as the oil and gas industry without any additional capex on our part other than completion of the WISE investment, as well as some pipeline capacity. So, we have about 20 miles of pipeline capacity that interconnects all 10 different water providers.

We own about 3 MGD, million gallons per day, of pipeline capacity that's interconnected to our partners, and really the benefits here are going to be we have additional supply, we have additional infrastructure, and then as you've heard me talk from time to time, this increases the opportunities for regional storage opportunity. So, a lot of that infrastructure is going to be interconnected to all of the participants in that, and there's a strong activity for participating and monetizing some of our very valuable storage assets on Lowry as well.

Moving to the next slide, I want to kind of highlight a little bit of the activity in the oil and gas space. That has picked up again this year. It has been very quiet for the last two years, but it has picked up this year. Interestingly, we have moved from having one dominant operator here who is still dominant, but we now have two other additional operators. We have three different operators now in this field who are picking up mineral leases and then doing their own pooling of mineral estates for each of their individual wells, and we look to have at least two of them active with rigs this year.

We're likely to see two rigs working the field the latter half of this year, probably somewhere in the 10 to 12 wells in the rest of the year, and ultimately, it kind of depends on the frack designs. These typical frack designs are about 10 million gallons per frack. We actually did one at the end of last year for one of the new operators that was twice that, so that kind of set a record for us in terms of water deliveries for a particular frack. That was about 20 million gallons for that particular frack.

At 10 million gallons, we generate about $100,000 per well, so we're excited about having that resurface for us, and that's a very good opportunity for us to deliver available water supply in the area. Some of the investments that we have in the water transmission line will continue to strengthen our system and really extend our reach on serviceability to that to continue to make it more efficient for oil and gas operators to get their water deliveries to their individual wells.

The next slide really just drills down in some of the specifics that many of you already know about—the Niobrara formation, the multiple formations, continues to be a good opportunity for us for the foreseeable future. We continue to be excited about that opportunity.

With that, I'd like to talk about some of our numbers for the first half of the year. The next slide really highlights our quarter, six-month end, so revenues are up about a third than previous year, and that's almost entirely attributable to the return of oil and gas opportunities for us. Our municipal water, sewer revenues are up slightly but that's probably a little bit more seasonal, probably due to a mild winter, so we had a little bit more activity on the water side over the winter months, and then our oil and gas revenues continued to contribute very nicely to our cash flows.

We're in the decline curve of that. We've had that leveled out for the last three years, so we've seen about two and a half years of production out of our oil and gas wells. They're still pumping through a gas-driven field, so we still have very, very robust production out of our oil and gas wells.

Moving on to some of the specific numbers, our balance sheet remains very strong and very liquid. We have approximately $30 million of cash, no debt. Investments for the first half of the year really are concentrated into the Wild Pointe acquisition. We spent about $1.6 million on the Wild Pointe acquisition, our Sky Ranch pipeline, about $4.3 million for the Sky Ranch pipeline. We invested about $200,000 into finalizing the WISE Interconnect System, and then continue our engineering and development of the Sky Ranch system, the real estate system out of that. That really has been some of the investments that we've made for the first six months.

Income statement continues to grow showing the strength from the oil and gas activity. We look for continued strength in oil and gas the remainder of the year as well as sort of starting to receive initial deposits on lots for the sale of our lots to builders for the first phase of this.

With that, I guess I'd like to turn it back over to the operator, open it up to the public for some Q&A and see if there's some color that I can drill down specifically for anybody on our first half year of operations.

Operator
Thank you. The floor is now open for questions. [Operator instructions.]

Our first question comes from Aaron Steele. Please state your question.

Q: Hi, Mark. Thanks for taking the question. Just looking at the Wild Pointe acquisition, when did that officially close?

Mark Harding – Chief Executive Officer
We closed that in December, and so we're just starting to recognize revenue attributable to that. In fact, the nice thing, and I should have pointed this out in the text of the call is we're going to start to see tap fees start coming in. So, we've already received tap fees from new connections out there, some tap fees from commercial connections and then also additional residential units. So, quarter-over-quarter our third quarter you're going to see tap fee revenue coming in and then expansion to our customer base and usage revenues coming in attributable to that acquisition.

Q: Okay. And, then, are those tap fees similar to the tap fees you will be planning on receiving at Sky Ranch?

Mark Harding – Chief Executive Officer
Great question. Because the system that we picked up is a fully developed system, what you're likely to see is really the margin component of those tap fees. Our tap fees are around $30,000 per connection, combined water and sewer, and that's about a 50% margin over the capex on that. You're going to see that $15,000 margin component because there's not that amount that's going to go to the capex. That's going to be $15,000, but we don't have any additional capex attributable to it.

Q: Okay. Excellent. And, then, maybe just on the outlook for the frack water supply, how many wells were in the company's supply line for the first half of the year?

Mark Harding – Chief Executive Officer
Just the one. For the first six months, we had the one which was the 20 million gallons frack, so that was about a $200,000, a little more than $200,000. Some operators have brought new designs to that that are increasing the water call on that, some operators may keep with the same frack design, so we'll wait and see how each operator kind of forecasts that in.

What we're planning on is just kind of that 10 to 12 well limit for the remainder of the year and the experience that we have at that 10 million gallon, $100,000 per frack opportunity.

Q: Okay, perfect. And then, on the royalty interest, you saw that the decline curve, it's kind of been slagging out a little bit here, continuing to see that, maybe two and a half to three year. At any point are those wells likely to be re-fracked?

Mark Harding – Chief Executive Officer
They will. Typically, what I have seen from other wells in the Niobrara formation is that's sort of a five-year cycle, so we're about halfway through that five-year cycle. They come in and I do know that they are reworking our well right now, so I'm not sure what they do when they rework that well, but we'll play close attention as to see what the production is off of a rework. It's not a re-frack, but it is a rework where they'll go in, they have some equipment there that they're doing some stuff down hole on, and then we'll see that that does to stimulate additional performance out of the well and then watch very closely how they start to re-frack some of these wells.

Now, that's our particular well. We'll start to see some of those re-fracks that are a little bit older because our well was the last well drilled, so some of those first wells that they're going to be drilling might be within a year of that scheduled five-year rotation and fracking. So, in addition to having some of the drilling activity go on, you might start to see that start to ramp up from a rework of some of the existing wells that are in the formation.

They drilled about 40 wells, so we have 40 operating wells that we supply the water to currently in the formation. Why we like this space is not only is it a very efficient way for us to deliver water through the infrastructure that we have invested and I think that partners very well with our oil and gas operatives because it's very efficient for them to take those deliveries, but it also allows us a significant opportunity for the capacity that we've built over the years. We look to serve that capacity for our residential customers, but we have about 1.5 million gallons a day capacity, and that's enough capacity to serve a couple thousand homes. We're still very long on our production capacity compared to what likely absorptions are going to look like from our residential development.

Q: Then, on the Sky Ranch side, what is the timeframe on that first phase, and then, have you gotten a sense of maybe that appetite for the builder lot takedowns, kind of what those would be on a quarterly basis?

Mark Harding – Chief Executive Officer
I do. I have a lot of specifics on that, but I probably can't give you too much of that in advance of having those agreements finalized. We are working with multiple builders, so I'll tell you we have three builders that we're working with, all are demonstrating significant interest. They want to put a lot of salesforce out there because this is one of the few places where they can get entry-level product. Each of them have product that they're very specific about that they're not going to overlap each other, they're not going to cannibalize each other, but yet they consider very distinct market segments on that. We're happy with the group that we're working with, and what I hope to do is probably have some clarity to that within that 60- to 90-day window.

And, frankly, what I'd like to do is probably get another call out there so I can really detail out the specifics of that for you all at that time. Let me reserve some of those details and I'll save some of that powder for that particular call.

Operator
And our next question comes from Geoffrey Scott. Please state your question.

Q: Good afternoon, guys.

Mark Harding – Chief Executive Officer
Hi, Geoff. How are you?

Q: Well, thank you. A quick question on the tap fees. How will you recognize them on your financial statements? Which line item will they be in?

Mark Harding – Chief Executive Officer
You'll see a specific line segment for tap fee revenue increase, so we have operating revenue that's come in, and that's a year-over-year operating revenue, and then you'll start to see it's been a number of years. This particular tap is a new tap for us. We had some commercial taps that we recognized that were part of building our system and we amortized those over a longer period of time. This one is where we're selling residential taps and because all of the infrastructure is built and delivered pursuant to that, we'll be able to recognize those taps all concurrently with that because the sale cycle of that will have been closed. But you'll start to see that as a reportable revenue segment within the income statement.

Q: Okay. So, right now one line litem is industrial water use for fracking, one is water and wastewater, one is other and there will be a fourth item called tap fees received?

Mark Harding – Chief Executive Officer
Yes.

Q: Okay. Going to Sky Ranch, you are kind of working with the housing developers to design product. How do you go about designing the commercial side of it? First of all, what is going to be the percentage of Sky Ranch which is going to be commercial or a number of acres or whatever, and then how do you go about deciding one supermarket, three banks, forty fast foods, one dry cleaner. How do you go through that process? Are you doing this by yourself or are you working with somebody?

Mark Harding – Chief Executive Officer
I am not doing this by myself, as my wife continues to highlight my limitations in this world. I am not that guy, so we have brought in a team to do that. We're working with CBRE to be able to help us navigate those fields. I have a listing agreement with them and really taking a look at that front corner, so call it 160, you take that corner section up there, it's probably not quite even math as the 160. But, you take a look at that front corner up there and say those are really right up along the interstate, and if you tuck yourself in that northeast corner, that's probably pretty good activity for industrial space because it doesn't need the visibility.

Right on the interchange, you're probably looking at retail space because it has high visibility, high traffic flow and then transitioning between those two, and that's about as much about commercial as I know. Then, also feathering in where you have the commercial, then you'll feather into some multi-family, so that'll maybe some multi-family mixed use apartment type product and then maybe attached product and then feathering down into the detached single family product.

There is a transitional area, and so, really, we work with both the commercial realtor guys that work with our land planners to really segment that out and say okay, here's what we're seeing in the market. We have a high degree of flexibility within our zoning to really establish those pads in any way we want. We have some infrastructure that we can set the whole thing up efficiently and then each individual pad, and pads may range from an acre to maybe 20 acres depending on the type of use on that.

If you take a look at that as a percentage of the overall project, it could be 20%. We're looking at maybe 600, 800, maybe even as much as 1,000 in single family connections attributable to the commercial activity up there.

Q: Yes. What are you thinking about in terms of total value of that commercial part of it?

Mark Harding – Chief Executive Officer

Good question.

Q: You're going to be selling us off completely with no residual value other than the water service rights.

Mark Harding – Chief Executive Officer
Yes, we'll have that, but there may be some areas where we'll maintain the super pad and do that on a per-square-foot lease-type basis. We're evaluating that, so whereas you're selling—I can sell a single family fully developed lot where somebody has a building permit on that, a 50-foot lot for $75,000, but I might be able to sell a commercial pad for $4 or $5 a foot. We bought it by the square mile, and in some cases we're going to be selling it per square foot. So, this is going to be pretty attractive way of us continuing to monetize that.

We don't want to necessarily be in the leasing business, that's really not our business model. We're going to favor those types of opportunities where we can sell it on a super pad basis to somebody that would like it that way. And, frankly, what we've heard on that is because so much of this property right along the interchanges, along the interstate is owned by people who only lease it by square foot and there's really a dearth of people out there looking to say yes, I understand that, but I'd really like to own my own building, my own center. That's great. We're that type of guy because that really doesn't fit with our long-term goal. While we like to build a recurring mode through usage revenues, we're also cognizant of trying to stick to those things that we're good at.

Q: Looking out over a five-year development process of the commercial side, is there a range of dollars that you could be talking about in terms of total sale proceeds?

Mark Harding – Chief Executive Officer
Well, Geoff, I don't have a good guidance for you on that.

Q: No even $25 million range?

Mark Harding – Chief Executive Officer
I don't. I'd by pulling something too far out of my rear gear to be able to give you a number on that. I do know that corner is going to be price per acre significantly more valuable than our residential price per acre, maybe three to five times more valuable per acre than our residential components.

Operator
There appear to be no further questions at this time.

Mark Harding – Chief Executive Officer
Okay. So, to the extent that anybody couldn't get the technology to work for them but had a question, certainly feel free to give me a call, and we can drill down into some specific color of some of these things. Again, we have made substantial progress in all elements of this. We're delighted to have the residential opportunities to be opening up sometime later this year. We're delighted to have oil and gas activities return. We're going to see multiple phases of this project going on concurrently, so while we'll have three builders working simultaneously on this first phase, we're looking to have multiple builders, multiple phases and multiple categories between residential, commercial activities going on at the same time.

So, the company is really excited, our board is excited about the progress that we've made, sharing the talents of all the board members, and they're all weighing in significantly. Our management depth is not just me out there in the marketplace. I have significant strength and significant support from our board, a great management team, so we're excited about executing on all avenues of what it is that we're doing.

Stay tuned and please don't hesitate to reach out and give me a call with any questions. Thank you, all.