Participants

Mark Harding, CEO at Pure Cycle Corporation (PCYO)

Nate Abercrombie, The Stock Podcast

Interview Transcript

Nate: Mark Harding, thank you so very much for doing the first follow-up interview. It's a pleasure being back here in front of you and seeing you again.

Mark: Well, thank you. It's a pleasure to be with you again this morning.

Nate: How have things been?

Mark: Things have been very good. We have had a lot of activity in the last 18 months or so since we first met and really excited about the progress that the company has seen over that period of time. So I'm happy to be able to share that with you.

Nate: I'm excited to talk about it and especially since I also get to see it firsthand driving down I-70 and seeing all the construction out there. So, it's very impressive.

Mark: You know and we're one of those companies that it does have an impact when you get a chance to visit it. You know what I mean? The visual impact of seeing a development, seeing where we are positioned in the metro area, the access that we have to transportation, how our facilities come together, the proximity of oil and gas development and the push that that industry has as it tries to coexist with an emerging and expanding residential area. And then where we're developing our water resources all have a very good feel once you have a chance to see it. So, I'm glad that you had a chance to drive by.

Nate: Yeah. You have your investor days out there, right?

Mark: We do. We do.

Nate: When is the next one?

Mark: So, we do those every summer to give everybody an opportunity to come out and see the progress that we're making not only in the development side of what it is that we're doing with Sky Ranch, but also how our water utility is expanding some of the reservoirs and giving everybody that view of what it's going to be like if you're somebody looking for a home out here. What it's going to be like delivering water or waste water services to customers that we have in the area. So, we did this one in July. I think that's been a good month to do that. I think it fits with most folk's schedule. It's been very well received for the past two years so we'll keep that probably going every July. Patterns itself well within what it is that we're doing on how we report our earnings. We're on odd fiscal year end, we have an 831 fiscal year end which is off cycle to most public companies. And then that puts this right in squarely towards the end of our fiscal year.

Mark: We typically do earnings calls twice a year rather than three times a year just because of it doesn't change all that much and so kind of laws to being in a position of updating investors with the same information. So I think couple times a year presents itself well. So we do one in November to report on our fiscal year end results and then we do one at half year, which is typically around April. So then that July cycles itself very well and in between those two. So, it does give everybody a very good perspective not only in what's happening on the season of the building activity but also cycling between our reporting periods.

Nate: Yeah. No, I really appreciate the fact that you do twice a year reporting because I think four times a year really is far too much, very short sighted.

Mark: Right. I agree.

Nate: So, if you wouldn't mind just providing just a brief overview of your business. I mean, I know people can go back to the previous interview and listen to a more in-depth overview of your business and how everything has evolved for pure cycle over the past, well, since 1980s, right? When you first bought this water rights. But a brief overview just for people who don't want to go back and look right now that would be really helpful.

Mark: Yeah, sure. So, I mean, at a DNA level we're a water utility. And we do what you would normally think of when you think of getting water and wastewater service from a provider. Typically, that provider is usually a city or a municipality, so they're government owned. If you look at water utilities throughout the United States, roughly 85% of all water wastewater activities are handled by governmental enterprises. So, only about 15% of those activities are handled by private companies like Pure Cycle. Our operating model happens to be in the state of Colorado in the Denver metropolitan area. And really the principle theory is owning water as a resource and we are in one of those unique areas where you can own water as a real property interest. And it's an area where there isn't a lot of water and so we have a fixed supply of water, Colorado only gets about, I'd say, 13 inches of rainfall precipitation in a given year. And most of it's all through the winter. And so, what we have is a semi-arid climate. We have a growing population base and so if you have a fixed supply of a commodity and a growing demand for that commodity that's what you want to own, right?

Mark: I mean, your macroeconomic class tries to tell you if you have a fixed supply, growing demand, price will adjust to that. And so we have been long on water owning water for a number of years and we continue to be in the market for expanding and strengthening that portfolio. We also look at how that component can add value in other areas. And so we find ourselves in a position where we picked up a land interest a number of years ago as a result of the fact that we had a water service commitment to that property and in the real estate downturn that property ended up going into bankruptcy. Our water commitment was tied to that land and bankruptcy and no one was really paying any attention to a water interest on that because adding water to a particular piece of property here in Colorado significantly enhances the value of it. And so, because nobody wanted to own real estate in 2010, we had an opportunistic buy where we bought about a thousand acres. It was ideally located, it was right along the interstate, it had an interchange right at the property itself, and it presented an opportunity for us to vertically integrate not only being the utility provider but also then to be taking a look at the development side of it.

Mark: Yeah and it was something that we weren't exactly sure we wanted to develop the property. We were probably more inclined to partner with somebody to develop that property, but that opportunity never really presented itself for us. And so, incrementally owning the property was a significant component of it, being able to develop the utilities was a significant component of it. And so, delivering a finish lot for home builders seemed to be that third legged a stool that if you had the first two, the third one was probably not as challenging as the first. And so, we decided to go down that path, really broke down about 18 months ago when we first met and really have had a tremendous amount of success delivering those lots. So, really taking a look at what the company does, we're a water utility, we provide domestic water and wastewater service in addition to the domestic site. Sometimes there's an opportunity to preside raw water for opportunities that's been another growing business of ours here due to being able to get oil out of oil shell. And so we got a number of major oil and gas operators that are in this field that are developing it. We probably had, I guess, water serviced about a hundred and thirty wells in this area and they use a tremendous amount of water for that activity as well. And so, between developing the water utility, using that water utility for the oil and gas space through industrial water and then also the domestic side with a little bit of real estate development on the side really it all underpins to that water opportunity.

Nate: Yeah. No, that's great. It's helpful. Do you feel like sometimes though when you speak to investors the oil and gas component muddies the waters, muddies the story for pure cycle because then maybe pure cycle gets thrown into the energy investment bucket that nobody really wants to pick up?

Mark: That's a common problem for us. If you really look at it, we're a water company and really participating in the scarcity value of water, but it's almost three different looks at it. Somebody can get their arms around a water utility. Very easy to understand water utility. There's companies that do that, they have customers, they deliver domestic water, they deliver waste water service, they manage those systems to customers. And so that whole industry is very definable. You got comparable companies that do that. And you take a look at providing water to oil and gas companies, well, there's oil and gas service providers that do that. And they transfer water from water supplies that they own or contract for from a water provider that may not be a miscible water provider, they're just an agricultural interest or something like that. And there's a whole segment of businesses that do just that, and there's comparables of businesses that do just that. And then there's companies that do real estate development and do that well and do nothing but real estate development. And finding a company that does all three of those, we find ourselves saying, "Well, what box do you fit in?" And we kind of fit in all three of them with the underpinning that really it's the value of the water that makes all three of them work, but I do find that challenge for folks to say, "Well, who are you like? And how would I compare you to another company?" Well, there are individual companies which you can use as metrics for that, but when you combine all three of them, we become unique company.

Nate: Yeah, yeah. So, could you talk about what's changed over the past year? If you'd like you start with Sky Ranch that would be probably most helpful because it's most obvious.

Mark: It is. It is. And I'd say that's probably where the bulk of our energies have been spent over the last year, 18 months. And really breaking ground on that what we were looking to do is be successful along delivering finish lots. And so, the project as a whole is about a thousand acres, it will have somewhere in a range of 3,500 residential dwelling units and then maybe another 2,000,000 square feet of commercial retail light industrial space at the interchange right along the frontage for the interstate. And if you equate that, and one of the things that we try to do is equate that to the number of connections that we're going to serve from the water utility side. That's roughly five thousand connections. So, what we look at is we'll deliver 5,000 connections to 5,000 equivalent lots. Now, some of those lots are going to be commercial retail, light industrial, schools, things like that. But if you equate it out to the number of single-family equivalents, that unit number is what we're trying to deliver. Our first phase we went out with about a hundred and fifty acres, we had a small out personal in our first phase looking to deliver 500, it's really 506 lots to three national production builders. So, we went out and started marketing our lots to 10 of the top home builders here in the Denver metro area. And really were pleased to have three very good national home builders, we got Richmond American Homes, KB and Taylor Morrison are our three home builders on that. And they roughly about a third, a third, a third to each of them in terms of the number of lots that they're getting. And really look to deliver lots, finished lots on an incremental basis.

Mark: And one of the things that we try to do is structure the delivery of lots such that our home builders can participate in that. So I manage the cash flows on that because it is a capital intensive model to deliver that. You have to grade out the property, sometimes that grading has economies of scale so you can't grade out just one lot. And as we were looking at it, it really made sense that we re-grade out all hundred and fifty acres all upfront even though we would deliver individual lots over a number of different take down intervals between the three builders but we wanted them to help participate to that. So they participated in some of that grading activity, they were able to pay us on an incremental basis when we would deliver a platted lot to them, they would pay us roughly one third of the overall value of a finished lot at the time we had that plotted lot that allowed us to use that capital to be able to incrementally do more with that activity. Then we got a second progress payment when we were delivering wet utilities. So that would be the water, the sewer, the storm systems that we would put in. And so, as you look at the progression of that, you do your grading activity then once you get that graded to where you want it, then you go back in you develop your wet utilities, once you get that done, then you start doing your curb gutter on your roads and then you hit your finish lot.

Mark: So, it was matching the way you would naturally progress through investing into that property. And so, that's worked very well for us. Didn't over-extend us in how we were investing into the property, waiting for that final payment. So, and the builders at that time they were also getting value incrementally. So, each interval and each payment they made their lots that they owned because we delivered them at the first phase of platted lot we're getting added value to it. So it was really good partnership with our builders in doing that. And so, as of today we've finished, I think, around 250 lots of finished lots. So we were little over right about halfway point of how much land we've delivered. We've closed on about 200 lots. So that's a terrific thing for us that we've been... gotten full funding on those 200 lots. So the builders will close on another 50 lots in probably Q1 of 2020 which is coming up because we're approaching the end of our fiscal year end. And then, can incrementally deliver the balance of it. So we have the wet utilities installed for all 506 lots. So we'll get payments for those, we should close probably in another 150 lots of the total so we'll be right around that, call it 400 lots of the 506 by the end of next fiscal year.

Mark: And what we've seen from the builder market is that there's been a tremendous amount of demand for what it is that we're doing. I think it's exceeded their expectations just because price of the product we're delivering an entry level product for them. And each of the builders are finding it very challenging to deliver that here in the Denver market. The price of homes, the cost of developing lots, the cost of building homes has almost outstripped the market's ability to pay for it. I use this example all the time. One of the things that you will see as you dig into some of the economics of home values and affordability and access here in the Denver market is prior to the downturn in the real estate market, roughly 50% of all new homes stats were going to be in that entry level home market basis. And that changes, right? I mean, as time goes on the value of what defines an entry level market continues to grow if nothing more than just inflation. And so what we define as entry level is that $350,000 home price. It's crazy to say that an entry level home, affordable home is $350,000 but that's really where it is here in Denver. And if you look at maybe that 2000 to 2006 timeframe, there was 50% of new home starts in that affordable index area. Today that's less than 5%, less than 5% of home starts now in the Denver market qualify for $350,000. And in fact, and it's interesting because the number of our builders out there if you go to any of the model homes and you start asking about the community they will tell you that this is the most affordable home in the Denver market right now. So, it's translated into a lot of traffic for each of the builders, each of the builders have come back to us trying to accelerate the take downs of their schedules because it's going better than they expected, allows us to monetize that sooner, to be able to deliver those finish lots that allows us to move to our next phase. So, all of those things seem to be really firing on all pistons today. Yeah, that's been our experience.

Nate: The developers do they build their homes on spec or do they build homes based on an agreement with a potential buyer? I guess which one is that, is it-

Mark: It's a good question. I mean, I think all home builders would love to have been paid for something before they break ground on it. And that used to be the model before the downturn in the real estate market. And I think they've been very successful about a high breed of that and also modifying the public's expectation on buying a new home. So, used to be when you wanted to go out and buy a new home or new build home you'd go in and you'd say, "I want this house," and you'd be able to move into that house the next week because they would build them on spec, they'd have a certain inventory of homes that they did that. And so what they find is that's been very difficult for them. They don't want it to inventory that. They're not sure what that capacity is. And so, while they'll build some model homes and they might start some of those homes in progress, they do want to actively get orders for those. So, it's really changing the expectations from somebody walking into a model home saying, "I can deliver this home for you in five, six months," and it also vests the buyer in that to say, "Okay and the reason we want to do that is we want your preferences. You know what types of cabinets do you want, how do you want this laid out, what types of colors, what type of carpet?" So they give them much more participation in the buying activity as opposed to buying something off the shelf. So, I'd say the majority of the builders will have a couple homes and inventory, and then most of them may do foundations for that and then when they start to go vertical then they'll want to have a contract for that.

Nate: I see. Okay. Yeah, just a quick comment on housing prices. I got my tax assessment earlier this year and it was up 50, more than 50% year over year.

Mark: Yeah, it's stunning.

Nate: It is. It is stunning. The way that the county assesses the value of my house going up 50% in one year. I mean it's just, and the year before that it was up 30%. I didn't contest it then, I contested it that time, I still haven't heard back.

Mark: Probably be challenging because they go back and say, "You know, every house around you is selling for this too."

Nate: Yeah. Yeah. Yeah. But as you were describing the development process, it occurred to me that you're not only the CEO of a water utility but you're also like a developer. You are a developer and you've been spearheading this process. And I was curious if, is there something you would have done differently as a developer. So not wearing the water utility hat, just as a developer, is there something you would have done differently? Something that you've learned through this process?

Mark: You know, I'll say about the road behind me on what we've done on the development over the last year. So and also the road ahead of us on how this thing is going to unfold. I very much enjoyed it. I really have. I mean, it is not that different than us developing a water utility. This business is about managing inventory and our inventory happens to be capacity. Capacity in a water plant. Capacity in a sewer plant. Capacity in a pipeline. Capacity in a water ownership, water rights portfolio. And so, that capacity translates into revenue over a period of time. And the development business is very similar to that. How much capacity are you going to invest into earthwork, into utility, into roads curbs and gutters, into offsite infrastructures? And can you match that capacity to deliver to a market that's willing to pay for it on a current basis? And so, when I looked at how we were structuring these contracts with the builders it was very similar. I'd found that to be rewarding, it's a new toolbox, so I look in there and I see how is it that we can build the expertise around that particular business and what we've tried to do here in the utility side as well as in the real estate development side is really bringing smart minds.

Mark: Work with talented people who've done this before. You know, when I first went to our board to say, "Hey listen, I think it would be in our best interest to develop the property ourselves." And they said, "Geez Mark, I think we have a lot of confidence in you but we as a board don't have that expertise. I won't be able to evaluate when you bring us a proposal as to whether or not that's a reasonable proposal. We have a high degree of confidence that you're going to do the best job on it, but as a policy maker we need to have that expertise on the board." And so they challenged me before we got into this is to find some expertise on the board to do that. And I was very fortunate to find one of the more senior people at Pulte. And he had just retired from Pulte, he was a young guy. Pulte first job out of college. Spent 30 years at Pulte going up and I think the year before he retired from Pulte he was responsible for 15,000 homes in the western US at Pulte.

Mark: And so he was here in Denver, we had met through a common referral and it worked out great. He was at the time looking to buy a contracting company, so he became now the owner of the largest pipeline contractor. And so he does a lot of work with cities and municipalities on the utility side that benefits him to have a little bit of expertise on the utility side and it benefits us a tremendous amount to have his expertise on the building side. And so, it was important to get that experience. I was forced to do that by the board, they were very disciplined by doing that, and it was the right thing to do. What would I do differently? Honestly we were very fortunate to have a low basis in the land. And I make lots of mistakes on developing the land, doing the stuff on utility. I try not to make them twice, but having a very low basis on the land forgives a lot of that stuff. And it's not that you make large financial mistakes. I mean, it's just time is a big component of this thing. How you deliver things, how you invest in that infrastructure. How that capacity goes. How you translate that into ownership and delivery of a finished lot. And if we had debt attributable to this, if I was chasing interest expense on this stuff, a lot of that stuff would have been a lot more difficult. So I was very fortunate that we were able to acquire the property at a very low basis. I think the property sold in 2006 for around $50,000,000. We bought it in 2010 for around $7,000,000. So our cost per lot is super low.

Mark: At the time we were engaged to be the utility provider out there. I was buying the water beneath the property. So I was going to buy the water beneath the property anyway and it would have cost me $3,000,000 to do that. And so I got the water with the $7,000,000. So really if you look at the basis in the land, it's $4,000,000 for 5,000 lots. So, I mean, I'm blessed than a thousand bucks a lot on my land cost. So, I'd be cautious to do that again. I don't want to be in a position to say, "Well, we're super good at real estate development and we should just charge off into the breach with more real estate development activity." There are opportunities where we can buy land that doesn't have water service. And the fact that we have water, bring water to it and increase the value of that land. And so we are in... we have our nets out for opportunities like that but to the extent that I would go back into the development side beyond Sky Ranch, it'd have to be a pretty unique situation to do that. So, I'm cautious about what that road ahead looks like. Knowing that the road behind us has been fairly well received and I think we've done a fairly good job at that, I'm always cautious about how what would look for us in the future given the fact that our DNA is still really a water utility company.

Nate: Yeah. Yeah. So, could you talk about phase II a little bit. So, I know that it's still down the road, you want to... you're focusing on completing phase I, but could you just talk about the appetite from builders and then I recall you saying that you're considering bringing in more than just the three builders that you currently have. Could you talk about why and just where you are on the development phase of phase II.

Mark: Yep. So we do have zoning for the entire project. All thousand acres and then what you do is you take that zoning and then you melt that to what the market wants at any given time. So we're working on that revised land plan right now with the local jurisdiction which is, we're in Arapahoe county here. And so we're working with the county on that. We've got a second set of submittals, second of three sets of submittals. So we're at a very advanced stage on this second phase. First phase was about 150 acres, second phase will be about 480 acres. So be much, much bigger. And it includes the commercial component right up at the interstate. So we'll have the commercial component, more residential component, a mix of product category. So when you have more space we'll still have the same detached single family homes, but we'll have a little bit more variety in that product. We're going to likely to have some attached single family residential products. So paired products.

Mark: And there's builders that are very interested in that, they specialize in an attached product and then, again, I think a higher level of demand for that here in the Denver area because affordability. We'll look at some multifamily, get some apartment-type of complexes out there. We'll look at some commercial areas so we can start to build up that tax base and continue to get some of the investment that we have in the roads, curbs and gutters back through a reimbursable agreement. And so, if you take a look at the land development side while we do get paid by our home builders, we also get paid by some of the reimbursables of the roads that others will own. So, when we build a road, we transfer that road over to the county, and the county ultimately will operate and maintain that, but the local tax base in Colorado sort of a growth pays its own way tax state. And so we have our own independent taxing jurisdiction that covers just the Sky Ranch development and those tax proceeds go to pay for those public improvements where we'll be reimbursed for those public improvements or start to see some of that come on a company's balance sheet and some of those opportunities later this year. We're working on a particular bond offering by one of the municipalities that we have on Sky Ranch to get us some of those reimbursables back.

Mark: But the commercial side has tremendous valuation. Colorado commercial is valued at four times the residential. So we're really a sales tax in center state attributable to that. But that second phase will probably lead with about another 800 to 900 homes as opposed to the 500 that we have. And we want to keep that size in a good delivery capacity. Again, we don't want to over-extend ourselves because the market will ebb and flow but we want to have a consistent demand cycle. Our existing three builders, all indications are more than just indications. I mean, they're very excited to continue on in the next phase. And then there's a couple of other builders that we're going to add to it that wanted it in the first phase and we're going to want to make some room for them. So we might have as many as six different builders in the second phase as opposed to the first three that we have. And then we'll also have some commercial buildings as well. So, the commercial side we're looking at how we would deliver a lot. We won't go vertical on that lot, but as opposed to delivering a standard, say 45, 50 foot lot by 110 foot deep, we're going to be selling the commercial piece by the square foot. So that will be a much more attractive opportunity for us than the residential side. So kind of looking forward to seeing how the market shapes up for that activity as well.

Nate: Yeah. Yeah. And have you announced a timeline what you're aiming for in terms of breaking ground on phase II?

Mark: We're generally talking about trying to break ground sometime next spring. So Colorado does have a season, you know we do have a builder's season although home builders can build year round. And so part of the reason why some of the home builders will inventory the foundations are there is a window of being able to pour concrete. And so, they'll get some foundations in the ground before winter sets in and then they can build vertically year round. They just can't cure that concrete in the winter so they might have a number of lots where they'll pour that. And then some of the dirt work and it just gets, you know, it gets soggy in the winter when you get snow and then five days later it melts and then just about the time it dries out you're going to get another snow so you're constantly chasing that. And so, what we'll probably do is a lot of the groundwork on the second phase, probably next spring, and then take a look at doing agreements, getting our builders lined up for very specific lots over this winter. And then being in a position to start the same cycle where we'll do, I like the structure of being able to deliver incrementally and get paid incrementally and take a look at how that's going to work for delivery of lots later in 2020.

Nate: And then on the phase II about how long you think, if everything goes according to plan and let's just say that there's nothing significant that happens to the housing market and the economy, in an ideal situation about how long would it take for you to deliver all of those houses in phase II?

Mark: That's a good question. I mean, everything always goes according to plan.

Nate: Yeah, exactly. That's why I caveat it.

Mark: That's right. I mean, you always good defense wins Super Bawls, right?

Nate: Yeah.

Mark: So, at the end of the day you really want to make sure that you're managing an inventory. And when you look at how home builders large production builders look at various projects, they like to be in a project where they have a couple three years inventory, they like to do anywhere from 6 to 10 homes a month. And so a couple hundred lots per builder is a good sweet spot for them so that they're not too long on lot commitments and understanding that a cycle may come to them. And so when we're looking at the first phase of this, we thought that might be a three-year build out. I think that might be accurate or even conservative, just given the demand traffic. So we'll see if that continues. It looks better once you've got homes up as opposed to a greenfield development. So, I think the second phase, having the first phase nearly complete will also look very well. And I would say with the six builders that should probably give us a little quicker absorption of 850 versus 500 because you'll have more players in there. But it still should be maybe a three, four year period for that. You'll have a little bit overlap. So we'll have some of the first phase winding down, the second phase winding up and then we look to continue to do that. So the next phase will be when the second phase is maturing and then bringing on the third phase and then the fourth phase.

Nate: And what about outside of Sky Ranch, is there anything, any developments that you'd like to talk about or highlight with respect to the water utility business that have happened over the past year to 18 months.

Mark: So we're very aggressive on that front as well. We did an acquisition of a water utility towards the end of, I'd say 2017. We picked up a small water system that had maybe 300 homes, they had maybe 200 homes built and then another hundred homes to go and then a bunch of commercial. So, it's kind of a small system, good metrics in terms of what we were doing, the water utility was fairly mature, you had to do some extensions on that and then you have to continue to build out the rest of your dance card in terms of the number of connections there. So there's lots of those out there that we're evaluating. There's a ton of energy being poured into the I-70 quarter right in the sweet spot of where we're at. And so, when you look at the Denver metro area you can't grow west. We've got a geologic barrier on the west side. So it's almost as if we're on the ocean. You just can't go any further west. So anything west of I-25 has been developed over the last 50 years and there's really no available land on that side. And then a lot of Denver grew south, right? Grew towards the south side of the Denver area. The land was more interesting, it was harder to develop, it was more expensive to develop, but it was more interesting.

Mark: So you have a lot of higher priced homes in that southern market that are very mature. And then you had the northern corridor or as you push out towards Fort Collins and a lot of growth activity on the west side of the interstate and then even some moving north east and really the underserved corridor has been the I-70 corridor. And you have the airport that has been a huge driver in this area and much like you see with all major new airports, they position them far outside of town and then the town seems to grow out towards that airport. And you see that right now. I mean, all of the projects that are being developed are all in this I-70 corridor. And so, there's a lot of land interest out here, a lot of developers are accumulating it and a lot of demand for water on this area. So, that's our sand box. We've got tremendous amount of infrastructure that's already there, that's ready to develop, ready to deliver incremental service. We can deliver connections one tap at a time, so it's very attractive for other property owners to say, "Listen, I think that it's time for us to put this property into the market. We're looking at breaking ground, would you extend your systems to provide water and wastewater service to that?" And that's an easy opportunity for us, and it's a very good relationship because it allows them to incrementally expand into their property where they don't have to have these huge upfront capital commitments on the water utility side. They can focus in on the land side, they can focus in on just the building of roads, curbs and gutter.

Mark: So, those are our target markets. We're targeting the I-70 corridor, our service area in Lowry [Colorado] as you go down in Lowry you see all the extension on the city of Aurora. We're right up to the boarder of the property. And so, there's a tremendous pressure point there as well is, you got this beautiful piece of property down there, it's ready for development, the city's grown out to it. When we started this thirty years ago, there was nothing out here. Now we've got development everywhere all around where we're at. So it seems to be, you wouldn't logically think that the area would grow out to it and I think we find ourselves in that position today.

Nate: Yeah. And how are you positioned relative to your competitors out here who can offer water services to some of these developers?

Mark: So, most of our competitors what I would traditionally refer to as our competitors are going to be cities and municipalities, right? So, I'd say it's probably the city of Aurora. They have a tendency to only want to serve what's been annexed into the city. A matter of fact they have a mandate, they can't serve unless you annex into the city. The city went through an annexation provision maybe 20 years ago and annexed a bunch of property on the north side of I-70. The south side Arapahoe counties largely unincorporated in Arapahoe county. And so, they've annexed more ground than they have capacity to serve, they're aggressively on in the market trying to buy more water resources to provide service to that, but any developer is going to look at, "Can I get my zoning in competing jurisdictions?" They may get their zoning in Adams county, they may get their zoning in Arapahoe county, they may want to get their zoning city of Aurora. And so they'll evaluate all of those opportunities and how much it costs them to deliver a lot in any of those jurisdictions and weigh what the opportunities are. I think our experience has been that it's been very cost effective to deliver lots in an Arapahoe county.

Mark: I think others which share that expectation that it's generally cheaper to deliver a lot in an unincorporated county as opposed to the city of Aurora. And they'll make their own decisions, but I think we have a competitive advantage. If you take water out of the equation, all things being equal it's likely that there'll be more activity in the unincorporated areas. And that's what we try to do. We try to take water out of the equation, give the developer that service that they're looking for and it happens to be contiguous to our area. So it's easy to extend those services for us.

Nate: Yeah. Yeah. So, I would like to move on to oil and gas and just hear your thoughts about the political climate has been a little bit challenging and now there's SB 181, so I'm just curious how that has influenced some of the operators that are here in your neck of the woods and just how those conversations have been going.

Mark: You're very kind. That's a nice way of describing a dysfunctionality as it relates to the relationship with oil and gas. So Colorado, I mean, we have a beautiful state and people have a preservation orientation to say, "Hey, I'm here but I don't want anybody else to come here. I want to keep this all for myself?" And you know, that's just not the way the economy works in this state or in any state. And so, what I typically look at this as just say, what we have is a very vocal minority of environmental interest that want to define and protect their particular area. And for lack of an analogy, let's just say Boulder rights, right? Boulder wants to say, "Hey, we don't want oil and gas development in the city and County of Boulder. And they couldn't stop it at the local level because the state controlled it. And so, what they tried to do is they tried to change the state law. And they do this every cycle like you say, and the state consistently says resoundingly, "No." We are a mineral-friendly state. We have had oil and gas development for a hundred years, we want to continue oil and gas development.

Mark: And so it has always been no. The most recent exercise was at the local level as opposed to the state-wide level. So instead of going to the voters who consistently say no, we want to develop oil and gas, and it is too big of a part of our economy they went to the state legislature and say, "Okay, you need to do more. You need to do more about increasing the regulatory climate, protecting residents, protecting the environment." And the state came back said, "Okay, let's take a look at that. Let's take a look and get some input from the oil and gas industry, let's get input from other governmental entities." And ultimately what they came up with as a compromise is to say, "You know what? Why don't we push this down to the local level? And if Boulder doesn't want to have any oil and gas activity, Boulder can choose not to have oil and gas activity. If Arapahoe county wants to have oil and gas activity, they can have oil and gas activity." So there could be a silver lining in that climate of increased protection centered at the local level because those that don't want it can say no, those that do want it can say yes. And that's what we've seen.

Mark: And so, in fact, one of the things that we saw was one of our operators who happens to be our large operator Conaco, got the first operator agreement in the state of Colorado since 181 past with the city of Aurora. And city of Aurora came in and said, "Yes, we think oil and gas is a part of our economy, it's a part of our state or part of our local municipal revenue stream. We do agree and respect our residents' need for more scrutiny, more protections in all the different categories, whether that's noise, light, air, operating conditions, water, transportation, all those sorts of things. So they worked with the industry, they worked with Conoco for months to come up with what would be a good operator agreement. And it's set the standard for the rest of the state. So a lot of other operators, a lot of other municipal jurisdictions were putting these agreements in place and are continuing to move forward with it. So, what it has done is it's allowed local jurisdiction, local representations to say, "Hey, I want more scrutiny on this or I want more limitations on this or I want more of this."

Mark: And without going by on a slashed earth statewide initiative to say, "I'm going to change it for everyone because I don't want this." So I think there's a good balance that we've struck and maybe we can get more predictability to it. Operators continue to drill, we still have that activity, it's a very good field. So, when you look at the cost per barrel of producing water out of the shell, it's as competitive as almost any in the United States. So, we're optimistic that that will continue to increase the certainty of what that climate looks like, and then have continued development in this field. One of the things we know is this field is very attractive. Right on top of where we're at. I mean, there is a ton of very productive oil. So yes, if you take a look at the regulatory climate, it still justifies developing it. Even though it might be more costly to drill here than it would be in Texas, it's still very, very productive.

Nate: Yeah. And any other head point or tailwinds that may be different from the last time that we spoke that you'd like to talk about?

Mark: So one of the things you never know, right? Are we in the eighth ending of this cycle or are we in the second ending of this cycle? And I think we've been in the eighth ending for the last five years. So a lot of people keep saying, "Oh, there's a recession around the corner, there's dark clouds ahead." And so, again, that goes back to defense wins super bawls. And you say, "I'm out there making these investments with a cognizant view that if things do shift where are going to be exposed and can we endure cycles in what are always going to be cycles, whether that's in oil and gas, whether that's in housing, whether that's in just the overall economy?" And so we try and make sure that we have a great balance sheet. And so I'll defend our balance sheet any day. You know we have a terrific balance sheet, we have good liquidity on it. We have no debt, we have tremendously undervalued assets, but there's not a CEO that you've ever talked to that doesn't say that. But we want to make sure that we can continue to support that balance sheet, continue to invest prudently where necessary and monetize as quickly as possible.

Nate: Yeah. It's good to have a cautious CEO and one who talks about defense a lot. So you talked about the balance sheet and I want to get to that. But before getting there and focusing on the financials, so once phase I is complete, you noted that revenues from a completed phase I should be around $750,000. Could you just talk about what that means in terms of cash flow, operating cash flow? And just for our listeners to understand how much cash your company will be generating once one phase, only 10% of the entire development, is complete.

Nate: And then from my perspective, I look at other water utilities out there and water utilities, the big public water utilities are very expensive when you look at the different multiples and would love to get your thought on what you think that a multiple of that cash flow would be an appropriate multiple for pure cycle to trade at.

Mark: I'm going to save the last part of your question to the back half of my answer.

Nate: Okay.

Mark: So, one of the things that always interest me about this industry and about water in general is the perpetuality to it, right? In a hundred years we're still going to be doing the exact same thing with water that we're doing today. It's such an essential component of our day-to-day lives, right?

Nate: Yeah.

Mark: Maybe we won't irrigate as much outside because we'll be much more conservation oriented and things like that, but the amount of water that gets used at a residential level, that customer is going to be around forever. And so that, all investors want that cash flow. I want that year-over-year revenue. And what risks are there against that year-over-year revenue. This industry is about as good as it gets.

Nate: Yeah.

Mark: Right? I mean, you're going to get... people are going to pay their water bill, every month they're going to pay that water bill. And so, when we're building these water systems and Sky Ranch's case were vertically integrated delivering the land as well as utilities. That won't be the case in all of them. We'll be delivering... our portfolio can deliver water to 60,000 connections. And so, if you look at what we get on a monthly base is we typically get about a thousand dollars per connection per year on the water side and about $500 per connection per year on the waste water side. So, call it a 100, 120 bucks a month per home, per connection. We call it per single family equivalent connection. And that lags about call it when the home owner moves in. We do get revenue from our home builders, when they pull a building permit we get a tap fee which we've talked about. You know we get these large upfront tap fees which are the capital side of the business, I get $30,000 per connection on the front end fee and that's about a 50% margin business because we have to build this system, right? We have to build the water system and the waste water plants. So there's that capital component, but the other half of that is for the water, owning the water, having the availability, the scarcity value of water in general.

Mark: And then the ongoing revenue that $1500 per connection per year really starts when they pull the building permit. I'll set the meter and then I'll build the home builder. I mean, we have our home builders paying water bills before a home owner pays a water bill. So, those revenues become very predictable, very stable and you're right. First 500 homes if you equate that to that $1500 that's about $750,000 a year just to build out a Sky Ranch. Those 5000 connections, that's seven and a half million dollars year-over-year. And so, those are good stable revenue streams. What's the multiple in something like that? I love to be able to tell the market that they should value that more than any other revenue stream out there because of the predictability, because of the security in it. Is that a five, is that a ten, is that a twenty? I'd put that on the back half of that but the market's going to tell me what they think that's worth.

Nate: Yeah. Yeah. Going back to the balance sheet statement that you, the statement that you made about not having debt still and me asking the question last time and felt like you weren't panting but you just were essentially saying that we'll wait and see what happens. But basically your company is, you think that it's undervalued. I personally think it's undervalued. Why not issue a little debt and buy back some shares at this point? I mean, your stock has done fairly well over the past 18 months. When we first spoke, it was about at nine dollars and some change and now you're at $10 and some change. Have you issuing some debt and buying back shares or using some of your cash on the balance sheet to buy back shares, is that something that you would consider at this point in time?

Mark: So, probably not the debt side, but then you say, "Look, you're going to be monetizing a lot of this land and you're starting to get a bunch of money back and you're going to have a big balance sheet on the liquidity side, what options do you have there?" And I can answer that by virtue of giving you a philosophy. I'll give you my philosophy, probably a philosophy of our board. My philosophy is management says I think I have a pretty good idea of how to invest that money that would make more money than, say, inflationary rate. I think that there are opportunities for us in acquisitions whether that's an existing water systems out there, whether that's a little bit of land activity that we may be able to couple with water to make that land and water worth more. Maybe not developing it but still adding value on the landside, maybe some water to increase the portfolio, to increase usability of that portfolio, those sorts of things are all where those investments would interest me and would interest our board. If there's not, those out there or we don't find the right pricing on those because we're pretty disciplined about it. We were disciplined about the acquisition that we did when we did that and we want to continue that discipline because we're fiduciaries of this invested capital. If that's not out there yes, we do think our shares are undervalued, the market's undervaluing us mostly because we're invisible. I mean, we're not going to get any love from the investment bankers because we're not an issuer, right? The last time I did stock was in 2010. So, that's not going to sustain a machine of bankers that need deal flow. So, we're not going to get any coverage from investment bankers on that side.

Mark: On an industry side, there's people that cover the water industry, there's people that cover the oil field service industry, there are people that cover the housing industry but they don't cover us. So we're too small on that site so we don't get any love on that. So yeah, I do think we're undervalued. My laments on that typically are worry less about that and just execute. You know what I mean? When you execute people will find you and they'll evaluate the stock the way they evaluate the stock. But if that timing doesn't work out there's opportunities for share buybacks with some of that excess cash. And then at the end of the day you own a utility for the dividends. So we do look to that as an opportunity for us, but that's going to be more out of the recurring cash flow and the margins from recurring cash flow so you want to match those two together. So, while I didn't hope they didn't pond to you. I gave you the ideology that we would like at for that type of decision.

Nate: You did and I really appreciate it. So, what about investors? What have you been hearing from investors over the past year? Is there anything that has been a common theme that you've been hearing from the guys that either are currently own your stock or have been interested but they just haven't dipped their toes in the water yet?

Mark: One of the things that I find to be a consistent case, somebody will pick up on us at a conference or something like that. I'll present at a conference and it'll be the first time they hear the story and they'll say, "Hey, that's an interesting company." And they'll dig into the website a little bit, they're going to listen to your podcast.

Nate: Hope so.

Mark: Right. And ultimately it gives them a better flavor for what it is that we're doing, where some of the value is, what we think about when we look at how we would invest in the opportunities. And then they come out, they kick the tyres, they see it and the biggest question they said is, "How does anybody not want to own you? I mean, it's so compelling." And it is, because it shows really well right now. I mean, 10 years ago probably didn't show as well as it does today. And so, the lament I get more than anything else is exposure. How do you get more exposure? I mean, I can't be on the road every day, I have a day job. I mean, I run the company. And we've grown from say 12 people to 30 people and I've got solid people that run this company. While I try and provide some value I try also to get out of the way of the smart people that know what the hell they're doing on it. So let them do what they do well. But that's I guess our biggest lament is how to be more visual in the investment community and how to get people come in and take a look at it. Because if you do take a look at it I think we have a pretty compelling case.

Nate: Yeah. I hear that a lot from even companies valued up to two billion. They just don't have the exposure they'd like to have and that's partly because all the big active investment firms are focusing on just the big names that are out there.

Mark: And I find that so much money gets put in index funds now because they can't get there. They just can't meet with companies to differentiate themselves. And the people that do the work that get out there and they meet with management, they find opportunities they are differentiating themselves, but it's harder and harder. I got to say it is getting harder and harder.

Nate: Yeah. So when you do sit down with investors is there a question that comes to mind that never gets asked but you wish they would ask about your business?

Mark: Good question. You know, collectively they always want to know what are your downside risks on this thing and how do we make sure that you're cognizant of them and that you're managing them? The political risk is always there and I think people put too much weight to political risk because the politics change on a dime, right? I mean, what happens at the national scale is just as silly as what happens at the local scale. So, I find those questions meritorious but probably over-weighted. In the individual side execution is probably less asked but higher weight. And so when somebody says, "Oh jeez, you have all these great assets but can you build them?" And so, I think we've done a very good job with demonstrating that. I think people make that assumption but we focus a lot on execution and making sure that we're good at delivering that. And we're smart at delivering that, you know, we want to know how that capacity gets utilized in over what period of time. So, I talk about it a lot but I think a lot of people probably spend less time on the execution and more time on the political, and I tend to say, "Listen, I try and worry about the things I can control. And I can control execution, I can't control the politics."

Nate: One more question. Will you ever let me to go out to Sky Ranch and hunt?

Mark: Hunting in Sky Ranch. I'll tell you a funny story. We had a Conoco employee call me up one time and says, "Hey, one of my guys just got hit with some buck shot." And I'm like, "You got to be kidding me." And they were doing just that. We had a reservoir out there. There were a bunch of geese. And they were shooting over the reservoir into an oil and gas site. I'm like, "Oh guys, that's... do you see what's happening?" Now we're too urban for that. There are some people that used to go out there.

Nate: Yeah, yeah.

Mark: Pretty.

Nate: Anyway, Mark thank you so very much for your time. It's been a pleasure to sit down here in front of you and talk to you again, once again about your business so thank you.

Mark: Well, I appreciate the opportunity. Thank you.

Nate: My pleasure.