Brookfield Residential Properties, Inc.

2013 Third Quarter Results

Conference Call Transcript

Date: **Wednesday, November 6, 2013**

Time: **11:00 AM ET**

Speakers: **Alan Norris**
President & Chief Executive Officer

Craig Laurie
Executive Vice-President & Chief Financial Officer

OPERATOR:

At this time, I would like to turn the conference over to Mr. Alan Norris, President and Chief Executive Officer. Please go ahead, sir.

ALAN NORRIS:

Thank you very much. Good morning, ladies and gentlemen, and thank you for joining us for Brookfield Residential's Third Quarter Conference Call. With me today is Craig Laurie, our Chief Financial Officer.

I would, at this time, remind you that in responding to questions and in talking about new initiatives and our financial and operating performance, we will make forward-looking statements. These statements are subject to known and unknown risks and future results may differ materially. For further information, I would encourage investors to review the corporate profile on our website.

We achieved solid financial performance in the third quarter and the first nine months of 2013, with results continuing to build. For the nine months ended September 30th, 2013, our income before income taxes increased 28% and our net income attributable to Brookfield Residential increased 69% over the comparable period in 2012. Our backlog, on a unit basis, is up 18% from the same period last year, with the value of the backlog up 31% over the same period, driven by improvement in all regions.

As has occurred in a number of past years, we anticipate that the fourth quarter will, once again, contribute income before income taxes at least equal to the first nine months' income before income taxes, resulting in the fiscal 2013 results being significantly higher than 2012.

We continue to foresee long-term fundamental demand in the U.S. market, driven by the lack of supply of new product over the last five years and relative affordability of housing. Unemployment trends are slowly improving and inventory levels are still tight in almost all of our markets. Moving forward, we believe the U.S. housing market will continue to improve in the year ahead and the Canadian market will remain stable.

While pricing continues to improve in the U.S., there has been some flattening of the trajectory of these increases. We had anticipated that house price increases would moderate as new supply came on, and this has been somewhat exacerbated by the uncertainty created by the disagreement and debate in Washington, D.C. in September and October. While some caution has crept into the housing market due to the U.S. government's recent actions, we do feel comfortable that we still have a considerable way to go in the housing recovery.

Our Canadian markets of Alberta and Ontario continue to produce strong results. In Alberta, we have seen increases in both our lot and house prices of approximately 3.7% and 8.7%, respectively, since the beginning of this year. In Calgary, we have more approved lands than the majority of our peers, but there continues to be delays in approvals on a citywide basis. This shortage of approved serviceable land, together with ongoing job creation and the resultant in migration, are contributing to price increases. Moving forward, we expect our Canadian operations will continue to benefit from our strong market share within the energy-focused Alberta market and the supply-constrained Ontario market will continue to be a strong contributor to our results.

Based on current land holdings, we are optimistic about our increasing profitability continuing in 2014 and beyond. As we have stated in the past, by 2015, we hope to see results in the U.S. approach profitability levels currently seen in Canada, providing the market recovery continues. While there may be factors that impact the short-term pace of the recovery, the long-term outlook for our business remains very positive.

I'll now pass the call to Craig to speak to our financial results.

CRAIG LAURIE:
Thank you Alan, and good morning, everyone.

Our financial results in the third quarter improved over the same period last year. Net income attributable to Brookfield Residential was $35 million, or $0.29 per diluted share for the three months ended September 30th, 2013, and $63 million, or $0.54 per diluted share, for the nine months ended September 30th, 2013. This was an increase of $20 million and $26 million, respectively, when compared to the same period in 2012, and was the result of increased gross margin from higher home closings, combined with a decrease in income tax expense, which was partially offset by sales and marketing costs and general administrative expenses.

For the three months ended September 30th, 2013, total revenue increased 36% to $333 million from the third quarter of 2012, and gross margin increased $30 million to $99 million. For the nine months ended September 30th, 2013, total revenue was $801 million, an increase of 28% from $625 million during the same period of 2012, and gross margin increased to $227 million from $181 million, when compared to the same period in 2012.

Land revenue for the three months ended September 30th, 2013 totaled $71 million, an increase of $9 million, when compared to the same period of 2012, primarily due to an additional 77 lot closings and 11 multi-family industrial and commercial acre parcel closings, when compared to the same period last year. For the nine months ended September 30th, 2013, land revenue totaled $227 million, which was an increase of $12 million, or 6%, when compared to the same period in 2012. This was due to 102 more single-family lot closings, compared to the same period in 2012. Land gross margin was $41 million for the three months ended and $110 million for the nine months ended September 30th, 2013, a $4 million increase and a $1 million decrease, respectively, when compared to the prior year.

Housing revenue was $262 million for the three months ended September 30th, 2013, compared to $183 million for the same period in 2012. The increase was the result of additional home closings in all operating segments, with California seeing the largest increase. Housing gross margin increased $26 million, as a result of a 27% increase in home closings, and a 13% increase in the average selling price, when compared to the same period in 2012. Housing revenue was $574 million for the nine months ended September 30th, compared to $410 million for the same period in 2012. The increase was a result of additional home closings, primarily in the California and Central and Eastern U.S. operating segments, which are benefiting from the U.S. housing market recovery. Housing gross margin increased $47 million as a result of a 26% increase in home closings and 11% increase in the average selling price, when compared to the same period in 2012.

As at September 30th, 2013, our total backlog, including our share of unconsolidated entities, had grown to 1,329 units, representing $639 million of value. This was up 18% and 31%, respectively, when compared to September 30th, 2012. The units in value of our backlog at September 30th, 2013 was higher when compared to the prior year, due to stronger net new home orders.

Our Canadian operations continue to be strong, primarily due to a significant backlog of 619 units entering into 2013, combined with an increase in net new home orders for the nine months ended September 30th, 2013. The Canadian market has shown a steady increase in sales with its backlog units up 11% year-over-year.

The California segments increase of 49 units at September 30th, 2013 was mainly due to new community openings and increased activity, when compared to the same period in 2012. The Central and Eastern U.S. segments increase of 80 units at September 30th, 2013, when compared to the same period in 2012, was mainly due to increased activity primarily in the Washington, D.C. market and home orders from our Denver market, which launched its first community in 2013.

As of September 30th, 2013, our active home community, including our share of unconsolidated entities, increased to 43, up from 36 in the third quarter of 2012.

Our selling, and general administrative expense was $42 million for the three months and $118 million for the nine months ended September 30th, 2013, an increase of $10 million and $30 million, respectively, when compared to the same period of 2012. This was due to an increase in labor costs and headcount resulting from increased activity and higher sales and marketing expense as a result of increased activity in both Canada and the U.S. When compared to the first and second quarters of 2013, the general and administrative component of the expense is relatively consistent, with most of the increase driven by a higher sales and marketing expense linked to the increased activity.

Moving to our balance sheet, as of September 30th, 2013, our assets totaled $3.4 billion, which is an increase of $568 million, compared to December 31st, 2012. Our land and housing inventory and investments in unconsolidated entities are our most significant asset, with a combined book value of $2.73 billion or approximately 80% of our total assets. Our land and housing assets increased due to acquisition of a $298 million development activity and stronger backlog, partially offset by sales activity. At September 30th, 2013, we controlled 110,062 single-family lots, which included service lots and future lot equivalents and 169 multi-family, industrial and commercial service parcel acres.

Thank you for joining us in our quarter end conference call. I'll now turn the call back to the Operator, who will moderate questions.

OPERATOR:

The first question is from Adam Rudiger of Wells Fargo Securities. Please go ahead.

ADAM RUDIGER:

Hi, thanks for taking my question. In the past conference calls, you've given us some unit guidance, I think, on your expected lot and home closings, both in Canada and the U.S. I noticed that was absent from this call. I was just wondering if you had any update on those expectations.

CRAIG LAURIE:

Adam, this is Craig. So, obviously, we did give what I'd say is equivalent to income guidance through Alan's comments about the fourth quarter being equal to or greater than the first nine months. In terms of the unit count guidance, to your point, we didn't update it but what I would say is that we don't see any material differences in unit count versus what we gave last quarter. Obviously, you could have various puts and takes between the different components but I think overall, we're still comfortable with that unit count guidance.

ADAM RUDIGER:

Okay. Then, just, secondly, on land sales, always a topic of interest, just the lumpiness and the unpredictability of it, but could you talk about the pace of land sales this quarter and if the, you know, slowdown in the U.S. side of the business has changed either demand or your desire to pace for future land sales?

ALAN NORRIS:

Yes, Adam, it's Alan. The summer months were traditionally a little bit slower. We've still got a number of land sales predicted for Q4. We're not noticing too much of a slowdown. As I said earlier, the trajectory on pricing has definitely slowed somewhat, which I think is a positive thing, to be quite honest, but the appetite has not changed that much. I mean, the froth has been taken out in many of the markets, which I think is, again, a good thing.

ADAM RUDIGER:

Okay. Thank you.

OPERATOR:

The next question is from Sam McGovern of Credit Suisse. Please go ahead.

SAM MCGOVERN:

Hey, guys. Thanks for taking my questions. In your outlook, you talk about your expectations for the Canadian market to remain stable. Can you talk a little bit more about what you're seeing in the different regions there? Have you seen any slowdown at all in any of the areas?

ALAN NORRIS:

Yes Sam, it's Alan. If anything, actually, we're on track for an extremely good year in our Alberta housing operations, our Edmonton land operations, extremely positive. As I said in my remarks, pricing is up in both lot prices and house prices since the beginning of the year. We've seen some job creation in Alberta and it's still a fairly affordable marketplace and we've got a strong market share of anyone, as you're well aware.

On the Ontario side of things, we know that there's been some discussion on the high rise market, which we've talked about for years with respect to the pricing issues on high rise, but on the low rise, I think at most what's probably happened is some degree of flattening on low rise pricing. Absorptions are still meeting our requirements, with respect that there are so many units a month in most of our projects in the GTA, so we're quite comfortable. We're virtually on track for what we had predicted at the beginning of the year. As I say, the prices are fairly flat, but the absorptions have met all expectations.

SAM MCGOVERN:

Got it. In talking to the builders, it sounds like, you know, most guys continue to have a pretty healthy appetite for land, even despite the increases in interest rates. Have you seen, at the margin, any reduction in demand from the builders or not really?

ALAN NORRIS:

Is this in the Canadian context or U.S?

SAM MCGOVERN:

No, just across North America.

ALAN NORRIS:

No, I don't think so. I mean, I think a degree of caution, people just may be sitting back and saying, "Boy, you know, this mess in Washington has just sort of changed consumer perspectives a little bit" but I look at it as a blip on the road, to be quite honest. I mean, I think there's still an appetite for builders to secure lot supply going forward and each builder is in a different situation by region. Obviously, some are trying to load up because they are short, others are quite comfortable. I wouldn't say that they're going overboard on it, but I think they're all trying to make sure they've got their 2014, and now their 2015, lot supplies lined up.

SAM MCGOVERN:

Got it, thanks, and just in terms of M&A, you've highlighted your criteria in the past in terms of what you would be interested in, size, scale, et cetera, in regions, as well. There's been press reports, obviously, about M&A; it sounds like a lot of that has already sort of passed but can you remind everyone about sort of what your criteria is and when you'd be willing to sort of step out beyond that?

ALAN NORRIS:

Yes, I wouldn't say we're nicely stepping out beyond, I mean, anything that's more of the media stuff you're talking about has obviously been in the Wall Street Journal just recently. Our criteria still remains the same with respect to whether we're looking at a 100-lot deal, a 1,000-lot deal or a 27,000-lot deal, with respect to what we would be trying to do and we look at all aspects as to whether we think it is accretive for our shareholders and whether it adds value overall. So, I think our return criteria depends on the age of the asset, the maturity, the entitlement status, and then you look through that and then you superimpose if it's an entity issue, then you superimpose the other criteria on top of that. These types of things only come along once in a while, so we'll look at traditional assets and we'll look at entities, but we do this all the time, that's what we do. So, we'll see if we think it fits and we'll go through a process internally as to whether we think it fits then we'll take it to a certain stage or not.

SAM MCGOVERN:

Got it, and in terms of M&A, I mean, how much incremental leverage would you be willing to put on the combined entity if you found the opportunity to be attractive, and is there sort of a maximum threshold that you wouldn't want to cross?

ALAN NORRIS:

Our philosophy remains the same with existing assets or any new assets. I mean, I think the mix of assets that we have on our balance sheet today lends itself to somewhere in that, I would say, 46% to 56% debt-to-cap type thing, based on how much raw land we have, how much service land we have and how much housing work in progress. If we were to do an acquisition that was more raw land related, you would want to be funding more on the equity side, which would reduce the debt-to-cap side. If it was more on a service lot basis, then you can have a slightly higher leverage ratio. So, it depends on the mix of assets that you would be buying as to what that percentage debt-to-cap would be appropriate.

SAM MCGOVERN:

Got it. Thank you that was helpful. I'll pass it along.

ALAN NORRIS:

Thanks, Sam.

OPERATOR:

The next question is from Robert Wetenhall of RBC Capital Markets. Please go ahead.

DESI DIPIERRO:

Hi, this is actually Desi DiPierro filling in for Bob. Thanks for taking my questions. So, just looking at the Canadian segment, I think you kind of touched on it earlier with orders of 26% this quarter and, you know, the comment that you made about pretty stable growth going forward. Is it something that you would expect to grow significantly faster than the overall Canadian market, given your geographic exposure?

ALAN NORRIS:

Yes, I would think of all the markets in Canada, we're in the best markets for sure. I mean, the Alberta market has extremely good prospects and I think our land position is far better than any of our competitors, to be quite honest. So, over a period of time, as we secure entitlements, we would anticipate that our position in the Alberta market continues to improve and increase, quite honestly.

DESI:

Got it, and then on the pricing side, you know, just in Canada, some of the declines year-to-date and the ASPs for your homes, is that just a function of changing product mix or how are those prices actually trending in the overall market there?

ALAN NORRIS:

Yes, I mean, I touched on a little bit on some price increases in Alberta in my opening remarks, but I think the rest of it is going to be on mix. Craig, is that correct?

CRAIG LAURIE:

Yes, that's correct.

DESI:

Great. Thanks.

OPERATOR:

The next question is from Andrew Berg of Post Advisory Group. Please go ahead.

ANDREW BERG:

Hey, guys, just a couple of housekeeping questions. Can you tell me what interest was that was capitalized in cost of goods sold and with respect to SG&A, how much non-cash stock comp was reported in the quarter?

CRAIG LAURIE:

Sure Andrew. This is Craig. I'll deal with the first question. One thing I will mention is that we're filing our interim report later on today, so it'll have a lot of this detail.

ANDREW BERG:

Oh, okay.

CRAIG LAURIE:

So, in terms of the interest capitalized, we capitalized $8.7 million of interest and expensed to cost of goods sold $10.7 million.

ANDREW BERG:

Okay.

CRAIG LAURIE:

In terms of SG&A, share-based comp for the quarter was $4 million and we had an offset of $2 million for the change in the fair value of our equity swap. So, the net would be about $2 million.

ANDREW BERG:

Okay, and then just lastly, can you discuss liquidity and what the availability is you have with your bank credit facility and then under your unsecured preferred asset facilities?

CRAIG LAURIE:

Sure. So, in total, the number is about $950 million. I can just run through it. So, obviously, $250 million of cash, BAM facility at $300 million undrawn, and the revolver at $250 million is undrawn and then on the Canadian facility is about $150 million.

ANDREW BERG:

Perfect. Thank you.

CRAIG LAURIE:

Thank you.

OPERATOR:

The next question is from Chris Keller of Columbia Management. Please go ahead.

CHRIS KELLER:

Yes hi, guys. Thanks for taking the questions, just a couple from me. Can you talk about your gross margins in your Central and Eastern U.S. homebuilding operations? It looked like they were down kind of on a year-over-year and quarter-over-basis. Is there anything in particular going on there?

CRAIG LAURIE:

Yes, you're referencing Page 29 in the profile. So, as you said, really, that is just related to a mix issue; a little bit of mix in D.C. and then we did bring on some new homes in Denver, that's the beginning of that project, and we obviously do expect those margins to improve as we go forward, as early as the fourth quarter.

CHRIS KELLER:

Okay, thanks, and then on the other side of that, you saw really kind of robust improvement in margins in California. How should we think about kind of the trajectory of margins here over the next year or so?

ALAN NORRIS:

I think from a backlog point of view, I would say that we're comfortable with the backlog margin at least equal to where we are just now, if not slightly better, but I think going forward, some projects we already have underway, we anticipate pretty solid margins going forward from a California perspective. I think we'll start to see some of that improvement in the other areas, as well.

Again, the pricing trajectory that we saw for the first eight months of this year, we are not assuming is replicated, but we do still believe there's a trajectory there going forward, because there is still lots of room in housing recovery and from an overall U.S. affordability point of view. So, we think we're quite positive on a go-forward basis. Obviously, if you have to go out and replace land, you end up getting back into that normalized level from a margin point of view, but bear in mind, we own a lot of land already, so we're in the fortunate position that we have inherent gains in most of our land position already.

CHRIS KELLER:

Okay, thanks, and then maybe just one more question, I guess. How should we think about community count in both the U.S. and Canada into 2014? Should we still kind of expect modest growth there?

CRAIG LAURIE:

We haven't given unit count or community count guidance yet for 2014, but I think, to your point, we had indicated that our target community count for 2013 would be 44. Obviously we're at 43, so we're very close to that. What we did talk about is you wouldn't really see a huge contribution from those new communities in 2013; it would be more be 2014, and I think we still stand by that. So, I don't think you'll necessarily see that community count increase in a material way in 2014. A lot of that growth did occur in 2013 but I think you are going to see the benefit of those new communities having come on in late 2013 and really coming through in 2014.

CHRIS KELLER:

Okay. Thanks.

OPERATOR:

The next question is from Stefan Mykytiuk of Pike Place Capital. Please go ahead.

STEFAN MYKYTIUK:

Hi, good morning. A perfect segue for my question, which was it looks like sequentially, you opened one more community – or two – in California in Q3. Two, is that right?

CRAIG LAURIE:

I mean, certainly over the year, we've opened a material number and there have been a number that have come off.

STEFAN MYKYTIUK:

What I was wondering, at the end of June you had 11 in that profile and then 13 at the end of September in this profile unless those may not be apples/apples, because maybe some shut and some opened. My question was really, like, was there anything unique to the timing of when projects came on in Q3 and do you have, you know, as you said before, where you'll probably get more benefit in 2014 from some of these 2013 community openings. Do you think there is even a little bit of pick up going into Q4 from some of those projects that have opened recently?

ALAN NORRIS:

I think from a sales perspective, yes, but, obviously, not trying translating into closings.

CRAIG LAURIE:

Yes, that would be my guess.

ALAN NORRIS:

So, you could see some impact on the backlog at the end of the year hopefully, but not, obviously not translating into closings on bottom line until 2014.

STEFAN MYKYTIUK:

Okay, and then I think California, if I got through the profile correctly, there were very few lot sales in California in Q3. Is that a timing issue, is it reflective of kind of the pause in the market or what? Can you comment on that?

ALAN NORRIS:

I think it's mostly, in many cases, a lot of the lot sales tend to happen, I mean, the builder, from their perspective, they're trying to load up from a next-year production point of view, so they like to try and drag it out as long as they can, which happens in Q4 mostly, and then they've got the lots ready to be built and starting to be building and sales beginning of the year. So, I would say we definitely have a number of lot sales scheduled for Q4, and that's traditionally when most of them would happen.

STEFAN MYKYTIUK:

Okay, terrific, and any comments on Arizona, how that; you know, you entered that during the year, any kind of comments on how that's progressing and how you feel about that?

ALAN NORRIS:

I would say it's positive. We've taken a position in two other projects down there, in addition to the JV that we entered into on April 1 of this year, so we've beefed up the business a little bit there and the big project that we entered into, the Eastmark JV with DMB & Associates, is making good solid progress both on the residential and a number of other initiatives on the non-residential side. If you remember, it's a very large mixed-use project. So, we're getting good positive momentum on both fronts, I would suggest at this point, which hopefully we'll see some benefit; hopefully we'll able to report that, but the activity on the single-family side of things is very good and, again, we're getting some interest on the non-residential, as well.

STEFAN MYKYTIUK:

Okay, and just lastly, circling back to the lot sales in California, are prices still improving there or have they kind of stalled out? I know earlier in the year, it seemed like, as you described it, there was a lot of kind of froth in the market. What's happening with pricing on lots out there?

ALAN NORRIS:

Yes, I would say that, I mean, the pricing is still very positive. It's mostly Southern California we're looking at from lot sales at this point in Q4, and I would say it's good solid pricing from a variety of different builders on the other side of equation. So, it's all very positive.

STEFAN MYKYTIUK:

Okay, terrific. Thanks very much.

OPERATOR:

The next question is from Frank Mayer of Vision Capital. Please go ahead.

FRANK MAYER:

Alan, you alluded earlier to your strong land position in Calgary. I'm wondering if you would care to comment about your market share going forward, as your additional land purchases come into production.

ALAN NORRIS:

Yes, good question, Frank. Yes, I think, I mean, we've traditionally been in that sort of 25% to 30% market share range in Calgary. Depending on what other lands do come on, we think our positioning for three new projects that we have up in the Northwest, the North Central and the Southeast regions of the city, as we get them entitled, we think they're obviously, some of the best assets coming on.

What we can't necessarily predict as easily is what other lands might come on at the same time from other developers, or whatever. But yes, there is a chance our market share can increase further from that point on. I would suggest it's not going down, because I think we're probably the best positioned of all with respect to the future growth quadrants of the city.

FRANK MAYER:
All right. Could you attach timing and percentages to your comment?

ALAN NORRIS:
I can attach a rough idea on timing, I think. We've got three projects, one of them, we would be looking for hopefully by 2015/16, and the other two maybe by 2016/17, something along that range, I mean, but it's a challenging process, as many of you are aware, trying to get approvals, which is good and bad. Obviously, it's good that there is a form of barrier to entry for many others coming into the marketplace but the bad is that it's not as predictable as you would like to hope.

FRANK MAYER:
So, it's conceivable then that your market share could go over 30%?

ALAN NORRIS:
It's conceivable, yes.

FRANK MAYER:
That would be rather remarkable. Thank you.

ALAN NORRIS:
Thanks, Frank.

OPERATOR:
This concludes the time allocated for questions on today's call. I will now hand the call back over to Alan Norris for closing comments.

ALAN NORRIS:

All right, thanks very much everyone, for attending our call today. I'm looking forward to conversations with many of you over the next several months and then having an excellent Q4 that we can talk about in February. So, thank you very much, indeed, and thanks for your interest in Brookfield Residential.

OPERATOR:

This concludes today's conference call. You may now disconnect your lines. Thank you for participating and have a pleasant day.