Brookfield Residential

Brookfield Residential Properties Inc.

Q2 2011 Conference Call Transcript

Date: Thursday, August 4, 2011

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 call over to Mr. Alan Norris, President and Chief Executive Officer. Please go ahead, Mr. Norris.

ALAN NORRIS:

Thank you. Good morning, ladies and gentlemen. Thank you for joining us today for Brookfield Residential's Second Quarter Conference Call.

On the call with me today are Craig Laurie, our Chief Financial Officer, and Linda Northwood, Director of Investor Relations. I will provide some comments on the current market conditions and strategy going forward. Craig will then provide financial highlights for our operations and financial results.

I would also like to remind you that in responding to questions and talking about our new initiatives and our financial and operating performance, we may make forward-looking statements. These statements are subject to known and unknown risks and future results may differ materially. For further information for investors, I would encourage you to review our interim report and supplemental information package, both of which will be available on our website.

I thought I would share our thoughts on the markets, our strategy and our outlook. These comments are also reflected in my letter to shareholders, which was posted on our website yesterday.

As we mentioned in our previous call, and as you see in our public materials, we own substantial land holdings in three operating segments, made up of 10 market areas. In Canada, we have three markets, California four, and in Central and Eastern U.S., we have three markets. We build homes in all three Canadian markets and four U.S. markets. Our strategic land holdings in Alberta are our largest assets.

Our financial results for the first half of the year were respectable, albeit we anticipate a stronger second half given the underlying strength we believe exists in our Canadian markets. Overall, the housing markets in the U.S. remain very challenging. The spring selling season was slower than expected, and many predict that will continue into 2012. Until U.S. unemployment begins to decrease in a meaningful way, we believe we will not see a recovery in the U.S. housing market.

While many individuals can afford to buy homes today, as the cost of rental housing is now approaching monthly home ownership costs, they are choosing not to purchase a home, in many cases. This is due to a number of factors – lack of down payment, difficulties in applying for a mortgage, or fear of being tied down to a house in the event that they may have to move, or relocate for employment purposes.

All in all, there is a trepidation on the part of the consumer about committing to a house purchase today. We do believe, however, this sentiment can change quickly, when some degree of confidence returns to the marketplace. We should also recognize that not all markets in the U.S. will recover at the same time or at the same pace. We believe our markets to be better positioned than most.

In Canada, there have been some press articles recently concerning a housing bubble. When these are analyzed closely, the concerns surround, for the most part, housing prices in Vancouver, and high rise prices in Toronto. Neither of which are areas where we operate in.

House prices in Alberta remain 5% to 10% below the peak of 2007-2008. We feel very optimistic about the future in Alberta, with more than $100 billion of projects scheduled for northern Alberta oil and gas exploration. The resulting job creation is expected to create a great demand for both our Calgary and Edmonton land and housing operations.

With respect to strategy, ... In Canada, we believe future opportunities will mainly be normal market transactions, which will enhance our existing assets and can add to our already strong financial returns.

In the U.S., several types of opportunities exist today. We have short term assets that meet our return criteria under today's economics, and medium to longer term assets that need both expertise and capital.

In many cases, the existing owners of these assets – reluctant owners in many cases – feel that they can hold the asset until a recovery is forthcoming, then sell. They're now starting to realize that these assets may need to be re-entitled to address changing market conditions.

We believe, as an organization, we can offer both capital and expertise in a form that provides alignment with that current owner, as opposed to a fee manager, who does not have that alignment.

Touching briefly on the rights offering, which took place during the second quarter, as a result of the merger, as many of you know, existing shareholders of Brookfield Office Properties were given the opportunity to acquire shares in our company.

The resultant take-up by shareholders other than Brookfield Asset Management was $182 million, which we believe to be very positive, given the current state of the U.S. housing market. As a result of this, Brookfield Asset Management's investment in our company declined from a potential 91% down to 71%.

From an outlook perspective, we are fortunate to have a North American profile, which allows us to take advantage of stable Canadian markets and distressed opportunities in the U.S. if the housing recovery is, indeed, 18 to 24 months.

I would now like to turn the call over to Craig, who will discuss our financial performance for the quarter ending June 30, 2011.

CRAIG LAURIE:

Thank you, Alan. For the six months ending June 30, 2011, the financial results reflected continued strength in the Canadian market, while challenges remained in the U.S. market.

Land revenue for the six months ending June 30, 2011, increased 56% due to an increase in average lot selling prices and the non-recurring land margins from the change in business practice for lot sales in Alberta.

Home closings and housing revenue for the six months ending June 30, 2011 declined by approximately 34% in comparison to the same period last year. The decline in home closings is largely a result of the reduced backlog entry in 2011, and the slow U.S. spring selling season. For the six months ended June 30, 2011, total revenue was $416 million, compared to $415 for the same period in 2010.

For the three months ended June 30, 2011, total revenue was $236 million, compared to $273 for the same period in 2010. Fewer home closings resulted in the decrease in revenue during the second quarter of 2011, partially offset by an increase in lot sales.

Included in net income for the six months on an after tax basis is approximately $30 million; and for the three months ended, approximately $11 million, reflecting the change in business practice on lot sales in Alberta, which was offset by a decrease in revenue from home closings. Title transfers in Alberta are now recorded at the time of sale of a lot, and not on the ultimate sale to a homebuyer. An after tax, non-recurring land margin of approximately $38 million is forecasted at fiscal year of 2011.

Brookfield Residential's net income for the three months ended June 30, 2011 totalled $19 million, or $0.19 per share, compared to a net income of $39 million, or $0.34 per share for the same $0.34 per share for the three months ended June 30, 2010. The decrease is primarily a result of lower gross margin for the quarter, and the increase in interest expense, with the addition of the notes that were issued in connection with the merger and contribution transaction payable to Brookfield Office Properties.

Net loss for the six months ended June 30, 2011 was $38 million, or $0.37 per share, compared to net income of $57 million or $0.46 per share for the six months ended June 30, 2011, primarily reflecting the increased interest expense of $14 million in income tax valuation; a loss of $76 million.

Turning to our unit activity, the company currently sells from 22 actively land communities, and 35 active housing communities. From these communities, the company closed 1,008 lots and 240 homes for the second quarter of 2011, compared to 647 lots and 480 homes during the same period in 2010.

It's important to note that our lot closings may vary significantly from period to period, due to the timing and seasonal nature of lot sales. The company's average selling price of lots delivered was $146,000 compared to $152,000 during the same period last year.

In turn, the company's average selling price of homes, delivered, was $369,000, compared to $365,000 during the same period last year.

Net new home orders for the three months ending June 30, 2011 were 455 units, an increase from 374 for the three months ending June 30, 2010.

Moving to our balance sheet, as at June 30, 2011, assets totalled $2.6 billion, an increase of $28 million when compared to March 31, 2011, due primarily to increased accounts receivable with Alberta lot sales during the quarter.

Our land and housing inventory total $2.2 billion, or approximately 85% of our total assets, similar to March 31, 2011. Our housing and land assets include homes completed and under construction and lots ready for construction, model homes and land under and held for development.

Now, I'd like to turn the call back to Alan, who will make some closing remarks.

ALAN NORRIS:
Thanks, Craig. First of all, we'd like to welcome all new shareholders arising out of the successful completion of the rights offering. We will continue to manage your assets with an appropriate long term review that should reward us all in a recovering market environment.

In conclusion, we'd also like to recognize the contributions of Ian Cockwell, our Executive Vice-Chairman. After assisting in a very successful transition to the newly merged company, Ian will be leaving the company at the end of August. I would like to thank Ian sincerely for his years of service and his unwavering support through this process.

Thanks very much for joining us for the Second Quarter Conference Call. We're positive about the future, and appreciate your interest in our company.

I will now turn the call back to the operator, who will moderate the question and answer period.

OPERATOR:
The first question is from Alex Avery of CIBC. Please go ahead, sir.

ALEX AVERY:

Thank you. Alan, in the letter to shareholders, you allude to partnering with some land owners, I guess, to do some re-entitlements of, I guess, some U.S. properties. Is this just normal course business or is this a new strategy? And, if so, can you provide a couple of examples of things you've already done or things that you have under consideration?

ALAN NORRIS:

Thanks, Alex. I think it's a strategy we believe that makes some sense going forward.

I can't give you any specific examples other than we have had some discussions, but very preliminary with different groups. There's a number of people in the industry in the U.S. that can offer fee management services. But, I think what we offer is both capital and land experience. And, I think that's how we can differentiate. But, we don't have anything that's fit to print at this point in time, other than I think some people felt the recovery was forthcoming prior to this point. And, the longer they stay with some of the assets, they realize some of the challenges they may have administering an asset – even, if it's not active at this point, in order to ensure they maintain value. And, I think we can offer solutions for some of those somewhat reluctant landowners.

ALEX AVERY:

And, I guess you mentioned that you have been exploring some of these potential opportunities. Can you give an idea of the magnitude of opportunity that you see out there?

ALAN NORRIS:

Not really. I mean, they could vary all over the map.

So, I think it's a little bit early days. A lot of this came to light when we realized that there's some owners looking. There's a number of groups expressing some interest, but there's some that we, maybe, have to uncover as well.

So, I would say that most of these people would require a reasonable amount of capital if they wanted to do something with somebody like us. But, it's nothing that have taken to any great extent right now.

ALEX AVERY:

Okay, and, then, while we're on the U.S. market, you made some fairly vague comments about the U.S. housing market, and I appreciate that it's very difficult to say anything concrete. But, I think in some of your disclosure, you mentioned something to the effect that, if indeed the U.S. housing recovery is 18 to 24 months away, how should we interpret that? Is that you saying sceptically that it could be 18 to 24 months away, or --

ALAN NORRIS:

We've got a fair degree of knowledge as to what's going on in the marketplace, but not a broad breadth across the entire country. But, from two different reports, conferences, dialogues with various market economists, etcetera, I think this is a reasonably common position right now. We need to see some movement on the unemployment, and we're seeing nothing in the U.S. economy at this point. And, I think we do have to start to see that happening first before that confidence returns.

I do believe it could return reasonably quickly, once some of the ground swell of confidence comes back. But, I mean, I'm speaking as an observer, as well as somebody who's intimately involved with the U.S. market. I think we've got some ways to go before that groundswell of confidence returns. I mean, as I touched on in the letter, home rental or home ownership costs in many markets is fairly equivalent to home ownership costs. It just -- there's a degree of trepidation on the part of the consumer right now. So, I think the downside is that we could be a little bit -- you know, 18 months-plus. The positive is that there could be more distressed opportunities that present themselves.

ALEX AVERY:

Okay. And, then, Craig, just on, I guess, the change in practice around lot sales and the title transfer timing of recognition. Can you just remind us, I guess, how that arose and if you could quantify the rough magnitude of the impact in this quarter?

CRAIG LAURIE:

Sure. This was really an Alberta practice. We would do a lot sale, and we would not transfer title to the homebuilder – we would skip transfer and transfer title to the actual home buyer. And, so, therefore, you don't recognize the revenue until the transfer of title.

We now transfer title at the time of the sale to the homebuilder. And, so, all you're seeing is that the sales that occurred last year with the old title transfer, those are now coming through, as well as our current sales are also coming through. And, so, you're seeing both pieces come through.

During the quarter, and it's broken out on page 11 of the supplemental, of the exact numbers, but on an after tax basis, it was $11 million. On a pre-tax, it was $15 million.

The expectation for the year is on an after tax basis to be about $38 million, about $30 million of which has already come through for the first half of the year. So, about another $8 million will probably flow through in the third quarter.

ALEX AVERY:
Okay, and why was that change made? Just, that's the way the industry's moving, or?

ALAN NORRIS:
Yes, I think from an industry perspective, Alex, it's Alan here again. The industry practice in Alberta had been just to do the skip transfer at the end.

I mean, from a U.S. GAAP perspective, the title has to transfer to deal with revenue recognition. And, we always believed that the revenue -- that the actual recognition was when we consummated a deal with the homebuilder. And, we wanted to match that timing up to match our records.

So, we felt it was more appropriate to change the business practice, just to change the actual convenience of title, which matched up properly with when we felt the revenue was truly recognized from a business perspective.

ALEX AVERY:
Okay. All right, and, then, just lastly, there was some comments in the letter to shareholders about some optimism for the second half. I presume that relates to Canada and, specifically, to Alberta. You know, it seems like there's population growth and lots of capital being invested.

Can you just provide a little bit more detail around the, I guess, the outlook for the Alberta housing market and how it's shaped up in the first half, and --

ALAN NORRIS:

Yes, I would say in the first half, we're probably lagging a little bit on house closings just a touch, because we came into the year with slightly less backlog. But, we've had some good traction through the spring from an Alberta perspective. And, very good traction in Toronto as well, out of interest, on the sales side.

And, I would say that there's a bit more optimism, and there's some good underlying activity, both in our market, as well as in the job market, I would suggest, in Alberta. That gives rise to some positive feelings with respect to Alberta.

Somewhat, for the last six months, because we see some backlog on the housing side, and we've got a few things we're working with our builders, who have to replenish lot inventory. So, we're fairly reasonably confident with respect to that. But, I would say for the longer term in Alberta, unless something major happens from a U.S. or global perspective, we're fairly optimistic on the Alberta future, from an economic point of view. Albeit, we do have to keep in mind what's happening globally, because there's a lot of stuff going on. I mean, you read the stuff with Europe this morning, and the U.S., etcetera. So, we would be impacted, as everybody would be, but in a normalized situation, we're feeling fairly positive about Alberta right now.

ALEX AVERY:

Okay, that's great, thank you.

OPERATOR:

The next question is from Sean O'Malley of Wedge Capital. Please, go ahead.

SEAN O'MALLEY:

Hi, good morning, guys.

ALAN NORRIS:
Morning.

SEAN O'MALLEY:
Thanks for taking my call. A couple of things. The sequential in the year-over-year drop in SG&A was pretty substantial. Is that a result of lower levels of commercial activity? Is it from post-merger synergies, is there something else going on here that's, kind of, one time in nature, or is this reflective of a run rate we can expect from here on?

CRAIG LAURIE:
Sean, this is Craig. In the first quarter, as we talked about previously, was probably a little bit on the high side, it was about $26 million. We're just about $20 million in the quarter.

I think if we look back in our past quarters, probably, the run rate we would expect is between $22 million to $23 million, but we do expect it will move around somewhat.

SEAN O'MALLEY:
Okay. And, the land sales in California increased significantly this quarter. Was there a particular large deal that closed, or was there a series of smaller things that you guys were after there?

ALAN NORRIS:
We concluded three separate finished lot transactions, Sean, which took place in Southern California. And, that was basically comprised of the lot sales in the U.S.

SEAN O'MALLEY:
Okay. You said Southern California? And, then, you've not booked any impairments since 2009, which is great. And, that includes this quarter. How many projects did you test for impairment in this quarter?

CRAIG LAURIE:
Sean, this is Craig. We look at each and every project every quarter.

SEAN O'MALLEY:

Okay. And, with a gross margin in California on the quarter that's, basically, close to zero, I think zero, should we expect that there's some impairments in California that we may see before the end of this year?

ALAN NORRIS:

It was a bit of a weird quarter with respect to some of the closings actually happening, some within California.

It was a bit of a mix of some of the homes that actually closed. The volume wasn't great, as you know. But, some of the homes that we did close were fairly close to what were minimal margins at best. But, as we do believe -- that was just a particular thing on mix, whereas many of the other models have positive margins.

CRAIG LAURIE:

Yes, Sean, this is Craig. Just to give a for instance, the last quarter in California, home closings would have been close to about a 15% margin. So, as Alan mentioned, this is probably a unique quarter.

SEAN O'MALLEY:

Okay, so, more of a mixed thing. That makes sense to me.

And, then, finally, the share repurchase that was recorded in the quarter. Were those the shares that were repurchased for the employee stock program that you got from Brookfield Asset Management?

ALAN NORRIS:

Yes, that's correct.

SEAN O'MALLEY:

Okay, great. That's all. Thank you, good quarter.

ALAN NORRIS:

Thank you.

OPERATOR:

The next question is from George Smith of Davenport Asset Management. Please, go ahead.

GEORGE SMITH:

Hey, there. I'm wondering, you were just talking about impairments since 2009. Can you remind me the magnitude of impairments taken prior to 2009?

CRAIG LAURIE:

Hi George, this is Craig. In general, the impairments were, obviously, on the Brookfield Homes side with the U.S. exposure. And, it was in excess of $300 million.

GEORGE SMITH:

And, then, can you talk about, I guess, priorities for free cash flow and balancing use of cash for recycling of capital into the U.S. from Canada versus paying down debt.

ALAN NORRIS:

George, it's Alan. I think we were actively looking at opportunities on both sides of the border. As I touched on in my letter, I would say that the opportunities in Canada tend to be normal market transactions. There's very little distress, obviously, existing in the Canadian markets at this point, due to how stable they are. And, we just have to balance filling in voids where we have a need in the Canadian markets versus some of the distressed opportunities in the U.S.

I mean, we believe that the cash flow that we monetize out of our home closings, in both U.S., as well as the profits we make in Canada, we've got that available to look on both sides of the border. So, we don't really have a specific capital allocation either way. We're just looking at opportunities and where we feel it's necessary, and what were the right opportunities to allocate the capital.

GEORGE SMITH:

Are you generally comfortable with this level of debt?

ALAN NORRIS:

Yes, I think as we touched even on the Q1 call, coming out of the restructuring, both companies entered the merger with about 45% debt to cap.

We ended up at, roughly 58% as the result of the notes-payable going back to Brookfield Office Properties. The timetable for that debt is on the senior note, is over five years, and on the junior note, is 10 years.

So, we believe -- at the time, when the transaction was negotiated, we felt that that was the appropriate mix with respect to protecting shareholder equity and putting appropriate amount of leverage in over a longer period of time on an unsecured basis. But, they maximize both.

So, I think we're still comfortable. We'd still like to get the debt to cap down a little bit, matching up closer to that 45% level. But, we feel that that's highly attainable over the next little while.

GEORGE SMITH:
Great, thanks for the time.

OPERATOR:
There are no more questions at this time. I'll turn the conference back to Mr. Norris.

ALAN NORRIS:
All right, thanks everyone for attending and being on our call. And, we look forward to chatting with you at the end of Q3. Thank you very much indeed.