Brookfield Residential Properties, Inc.

2013 Fourth Quarter Results

Conference Call Transcript

Date: Wednesday, February 12, 2014

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, Mr. Norris.

ALAN NORRIS:

Thank you very much. Good morning, ladies and gentlemen, and thank you for joining us for Brookfield Residential's 2013 Year-End 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.

2013 was a rewarding year as we continued to harvest what has been, for many years, solid and reliable income and cash flow from our Canadian operations, while our U.S. operations capitalized on significantly improved housing and market conditions. Our income before income tax increased 33% to $172 million, and the net income attributable to Brookfield Residential increased 33% to $1.21 per diluted share. We achieved these results while continuing to build on our well-located land asset portfolio. In 2013, we completed $358 million in strategic land acquisitions, split almost equally between Canada and the US and at year end, we controlled over 110,000 lots, which positions Brookfield Residential as one of the leading asset-rich land and housing companies in North America.

As we anticipated, the U.S. housing market continued to rebound in 2013. While there was a small bump along the road midway through the year related to the tapering discussions and U.S. government shutdown, the U.S. market finished the year with new house prices up year-over-year. While the pace of recovery and supply has varied from region-to-region, demand has improved over past periods, which has led to rising home prices.

Our Canadian operations in Ontario and Alberta remained solid in 2013. In Ontario, our operations continued to perform well and the supply-constrained market is expected to be a strong contributor to our results going forward. In Alberta, we continued to benefit from our strong market share within the energy-focused market. We've a strong base supporting steady sales and positive economic fundamentals continue to drive housing demand and pricing.

In 2013, we increased our active housing community count, including our share of unconsolidated entities, from 33 to 47, and we expect to open 19 new communities during the remainder of 2014, with much of the financial impact to be reflected in 2015 and beyond. With the strength of the U.S. market, we've been able to advance the development of several new projects which were originally planned for 2016 into 2014. So, adjusting for communities that are projected to sell out in 2014, we expect to end 2014 with approximately 57 communities in active selling phases, including our unconsolidated entities.

Our strategy in 2014 will see us increase our involvement in mixed-use projects across North America. We have been developing commercial properties within our master-planned communities for decades and our disposition of these assets is consistent with past practices, whereby we create value in the retail asset by entering into leases and then selling to a REIT or other purchaser of income properties thereafter.

In Calgary, we have a very exciting project called Seton, which sits on 365-acres and is one of the largest mixed-use developments of its type in North America. Our vision of Seton began years ago, but came to fruition when construction began on the $1.45 billion, 45-acre South Health Campus, which opened in 2012. Our development plan includes 2.5 million square feet of office and retail space, light rail transit, a regional park, a public library, high school, regional recreation facility, hotel, and over 1,300 multi-family residencies. We are also developing four residential master-planned communities in proximity to Seton. In November 2013, we entered into a contract to sell the first phase of Seton, which included 128,000 square feet of retail space and is currently 96% leased. This asset is under contract for $73 million CND and is expected to close in the first quarter of 2014. The forecasted net gain on the sale will be approximately $35 million CDN.

Thanks to our sizeable land holdings within our master-planned communities, we have considerable control over product segmentation, allowing us to meet the needs of our local markets. Affordability remains strong despite price gains experienced in 2013 and we predict further home price increases in 2014, albeit at a slower pace. It is important to remember that due to the multiplier effect, a small increase in a house price can often translate into a larger increase in the underlying land value.

Our outlook for 2014 is positive and we anticipate that, based on current market conditions, income before income taxes for 2014 will be measurably higher than 2013. We offer the following limited operational guidance for 2014:

- Canadian operations are projected to close approximately 1,500 single-family lots, 30 acres of multi-family, commercial and industrial parcels, as well as 1,400 homes;
- California operations are expected to close approximately 750 single-family lots and 525 homes;
- Central and Eastern U.S. operations are expected to close approximately 1,000 single-family lots and 450 homes;
- Our share of investments in unconsolidated entities are projected to close 600 single-family lot equivalents and 70 homes.

This limited guidance does not include material bulk lot sales or other transactions, such as the sale of the commercial assets that may occur in Canada or the U.S.

Many of the lots and acre closings are projected for the end of 2014, and are subject to the normal timing risks of approvals in the development and closing process. As a result, if they do not close in 2014, we would anticipate it will occur early in 2015.

With respect to Brookfield Residential's prospects going forward, we believe that we are one of the best positioned land and housing companies in North America. Our strategy of 'going long' on land, when it was out of favour, should allow us to reap the benefit of increasing land values as markets continue to improve. We obviously have a number of disposition alternatives available to us in a rising and recovering market. We will also continue to evaluate large corporate initiatives as they are presented to us. However, our approach is disciplined and we will only enter transactions if they add strategic and accretive value to our Company.

While not giving specific earnings guidance, based on our current assumptions and forecasts, we would anticipate 2014's income before income taxes, including the Seton commercial sale, to be roughly a linear progression to the goal of 2015's U.S. results equaling that currently experienced in Canada.

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

CRAIG LAURIE:

Thank you, Alan, and good morning, everyone. As Alan outlined, Brookfield Residential had strong results in 2013. At year end, net income attributable to Brookfield Residential was $79 million, or $0.67 per diluted share, for the three months ended December 31st, and $142 million, or $1.21 per diluted share, for the 12 months ended December 31st. This was an increase of $23 million and $49 million, respectively, when compared to the same period in 2012 and was the result of the increased gross margin from higher home closings, combined with a decrease in income tax expense, which was partially offset by higher sales and marketing costs and general and administrative expenses.

Land revenue for the three months ended December 31st, 2013 totaled $146 million, compared to $407 million during the same period in 2012. The 2012 land operations included the Playa Vista sale of 195 lots and 22 multi-family acre parcel sales that resulted in $264 million of revenue and nil margins. Without the inclusion of the Playa Vista sale, land revenue increased by $3 million over the same period in 2012. Land gross margin was $63 million; a $2 million increase, compared to the same period in 2012. For the twelve months ended December 31st, 2013, land revenue totaled $373 million, compared to $622 million in 2012. Adjusting for the sale of Playa Vista, land revenue increased by $15 million, compared to 2012 and gross margin was stable.

Housing revenue was $409 million for the three months ended December 31st, compared to $308 million for the same period in 2012. Housing gross margin for the same period in 2013 was $85 million, a $35 million increase, compared to the prior year. The increase in housing revenue and gross margin was due to higher volumes with 131 additional closings, an increase in gross margin, and a mix of sales between the operating segments. Housing revenue was $983 million for the twelve months ended December 31st, 2013, compared to $718 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 increases. Gross margin increased $82 million as a result of a 23% increase in home closings and a 12% increase in the average selling price, when compared to the same period in 2012.

As at December 31st, 2013, our total backlog, including our share of unconsolidated entities, had grown to 915 units, representing $448 million of value. This was up 10% and 23%, respectively, when compared to December 31st, 2012. Canadian operations continue to be strong, with a steady increase in sales and 7% increase in backlog year-over-year. California operations experienced the most substantial price increases, as well as increased activity in new community openings, when compared to the same period in 2012. The Central and Eastern U.S. regions saw an increase in activity, primarily in the Washington, D.C. market and our Denver market, as our homebuilding operations was launched in 2013.

Our selling and general administrative expense was $170 million for the twelve months ended December 31st, 2013, an increase of $42 million, when compared to the same period in 2012. As a result of increased activity, general and administrative expense increased $23 million, primarily driven by labour and headcount costs, while share-based compensation increased $5 million. Our sales and marketing expense increased $14 million as a result of the increased activity in all our operating segments, when compared to the same period in 2012.

Our land and housing inventory and investments in unconsolidated entities are our most significant asset, with a combined book value of $2.6 billion, or approximately 78% of our total assets, as at December 31st, 2013. The land and housing assets increased, when compared to December 31st, 2012, due to acquisition of $358 million development activity and strong backlog, partially offset by sales activity.

In 2013, we strengthened our capital position with an issuance of $500 million of senior unsecured notes, due in 2022, and the coupon of 6.125%. Together, with a new unsecured $250 million U.S. revolving credit facility, we've improved our overall liquidity levels to over $1.1 billion, including $320 million of cash on hand and reduced our net debt to capital ratio to 42%.

Annually, we disclose our projections for undiscounted net cash flow from our land held for development and optioned land inventory. In last year's Business Plan, this amount was forecasted to be approximately $5 billion. In this year's Business Plan, our forecast has grown to approximately $5.5 billion. These cash flow projections represent the net cash flow through the development and monetization processes. Cash flows from joint ventures are shown at Brookfield's proportionate share. Inflation has not been built into the Canadian or U.S. cash flow projections. In previous years, certain long-term land assets cash flow forecasts assumed a return to a stabilized market condition. These assumptions have now been met. This number will fluctuate with the composition of the Company's inventory, as land moves into development or is monetized with the sale or joint venture structures.

Canadian cash flow projections comprise approximately 60% of the total future cash flows. The Canadian cash flow projections increased approximately 5% on a year-over-year basis, with over 70% of the future cash flows projected in Canada are projected within the next 10 years, with approximately 30% in the next 5 years.

U.S. cash flow projections comprise approximately 40% of the total future cash flows. U.S. cash flow projections increased approximately 15% on a year-over-year basis. In addition, we are advancing development in a number of projects, with approximately 85% of future U.S. cash flows projected within the next 10 years, with approximately 45% in the next 5 years.

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:

Thank you. We will now begin the question and answer session. If you would like to ask a question, please press star and one on your touchtone phone. You will hear a tone to indicate you are in queue. For participants using a speaker phone, it may be necessary to pick up the handset before pressing any keys. If you wish to remove yourself from the question queue, you may press star and two. There will be a brief moment while we poll for questions.

Your first question is from Dan Oppenheim of Credit Suisse. Please go ahead.

DAN OPPENHEIM:

As you think about 2014, you're talking about some of the projects in terms of land sales and such, and approvals and what's coming at the end of the year. If you could provide a bit a more clarity and then, also, a bit in terms of the mix, as you think about that, especially within California in terms of the mix of land sales.

ALAN NORRIS:

Hi Dan, it's Alan. Yes, we have a couple of projects that we're finishing off the entitlements and we're probably about a month away and we're literally letting construction contracts go in the beginning of Q2, which we would then be hopefully finishing off all of the on-site work required to sell lots by October, November, early December. So, we have a number of lot sales that fit into that category, and we have a few moving parts to get to that. That's really the point we're trying to make and those are specifically in California.

So, with respect to the mix from a housing perspective, we still have a fairly high average sales price going forward in California with a lot of the projects up, obviously up in Northern California. We'll now start to see some even coming from our Playa Vista project, for instance, in 2014, which is a high ASP, as well.

CRAIG LAURIE:

That's for housing.

ALAN NORRIS:

Oh, for housing. I apologize. Sorry, that was on the housing side, that last part. The first part was on the lot sales.

DAN OPPENHEIM:

Great. Okay. Thank you very much.

OPERATOR:

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

ADAM RUDIGER:

Hi, good morning. I want to talk a little bit about land gross margins, if we could. Obviously, they're a bit volatile and we understand the one-time nature of certain transactions can impact that, but I think many people, myself included, kind of try to use that metric as a way of valuing the rest of the inventory. So, could you talk about what drove the last quarter, it was 58% and this quarter 43%, so what happened this quarter and then what would be an appropriate range for us to try to think about going forward and if you, you know, try to smooth-line it all?

CRAIG LAURIE:

Yes, Adam, this Craig. So, I think, you know, as we've talked about, Canada has been relatively stable, usually between say, 50% to 60%; that will vary depending on the mix, really, between Edmonton and Calgary. As we've talked about, Edmonton has a slightly lower margin percent. In California, the line gross margin had about a 36% gross margin. We would normally anticipate that it would be between 25% and 35% in California. In Central and Eastern, we average 9% for the quarter, 7% for the year. As we've talked about, the big driver of that is just we had not been selling enough lots to really cover the inherent operating costs. In 2014, I think we would look to, with the unit count guidance that we should be past that, and again, we would target that say, 25% to 35% gross margin on lot sales in Central and Eastern.

ADAM RUDIGER:

Okay. Then, the second question I had you know, if you look back at what happened in 2013, the way the year started and then the way that it changed throughout the year, did that do anything to impact the multi-year disposition of lots in the U.S.; meaning did it accelerate your thoughts at all or did you see any change?

ALAN NORRIS:

It's a good point, Adam. It's Alan here. I mean, we obviously saw things sort of slowing down somewhat in Q4. I think everybody did. I mean, the trajectory that was going on in the first seven/eight months of the year was quite rapid in most regions but what we closed in Q4, from a lots sales point of view, and housing closings, was exactly as we had anticipated. We're still bullish on where the world is going and where we are in the stage of the recovery, specifically from a U.S. point of view, so we're continuing to move ahead on a consistent basis as to what we originally thought was, as a progression in 2014, and getting in 2015, as I touched on in my prepared remarks, getting our U.S. operations up to a level of profitability equal to where Canada is at this point by 2015, and we think we'll get there through a natural sort of almost linear progression, quite honestly.

So, we're still comfortable in the stage of where we are in the recovery. We definitely still need to see better jobs numbers and all the rest of it. I mean, we're still not quite sure, I don't think anybody is, on the December and January numbers that came out. I'd like to see a little bit more improvement on that side, but I still think we've got a fair ways to go on the affordability side in many of the markets and still also from an absorption point of view and getting up to a more normalized rate of sales for the country nationally.

ADAM RUDIGER:

Okay, makes sense. Thanks for taking my questions.

ALAN NORRIS:

Thank you.

OPERATOR:

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

SAM MCGOVERN:

Hey, guys, good afternoon. Just to build on the previous question; other than sort of the slowdown that sort of hit the entire industry in the fourth quarter, have you guys seen any change in the appetite or demand for land from the builders sort of on a go-forward basis?

ALAN NORRIS:

Sam, it's Alan. No, I mean, it's a good question, because we're down in Los Angeles now; we just finished some meetings with our people down here and, I think I would say that there was some trepidation probably in Q4, but I think has rebounded, and I mean, California specifically, had a very good January, I think not just us, but many other builders, as well. So, we've been having discussions with many builders about lot sales for later in this year, as I touched on earlier on and I think there is still a good sense of optimism and many, many interested parties coming to the table expressing a desire to buy lots. So, I think we'll obviously see the spring selling season but at this point in time, we're not seeing anybody holding back.

SAM MCGOVERN:

Got it. Then, to delve into a specific market, you guys talked a little bit in your press release about the Ontario market and relative strength there versus probably expectations. Can you talk a little bit about what you're seeing there? I think, you know obviously, there's prognosticators are talking about a potential slowdown there. Have you seen any indications of that happening so far or is it still sort of steady out there?

ALAN NORRIS:

Yes, we've probably seen some more incentives being offered on the high-rise market, which we're obviously not a party to, other than on the periphery. I mean, we're only in the low-rise business and consistent with past calls, I think I would say that our pricing was reasonably flat during 2013 but, we're opening up some new communities as we speak and we're getting excellent number of parties. We've got a new community opening up in Ontario and we have 3,000 people who have registered and have expressed a desire to look at some of the homes that we're going to be opening up. So, I mean, there's still a pent-up demand. I still think there's a shortage because of infrastructure deficit in that marketplace.

No question that the high-rise business still has some question marks around it, but we're not seeing much of an offshoot from that in the low-rise business. So, we're still comfortable. We occupied over 500 homes there last year and we're anticipating somewhere in that sort of region again for 2014 and we're sitting roughly with about a 70% backlog, if not slightly higher, at this point in time for 2014.

SAM MCGOVERN:

Got it. Thanks so much.

ALAN NORRIS:

Thanks, Sam.

OPERATOR:

The next question is from Will Randow of Citigroup. Please go ahead.

SCOTT SCHRIER:

Good morning. This is actually Scott Schrier in for Will. I wanted to ask you, your 2014 guidance assumes that you plan to close homes and lots that represent kind of a smaller percentage of your total controlled lots, as compared to your average back in the early 2000s, and now as we're ramping up toward mid-cycle, I just kind of wanted to see what's holding you back from getting the closings and lot sales up to that kind of percentage that you had back then.

ALAN NORRIS:

It's not a conscious decision on our part. I think it's really just the state of each of the parcels where we've re-entitled some and some of that will happen in either late 2014 or going into 2015. I mean, we continue to see a ramp-up over a period of time. Many of the municipalities still don't have as many individuals there on the planning and entitlement, they haven't geared back up again, so it's taking some time to get some of those back through a re-entitlement process, but we're comfortable with the stage of progress that we're going through. Consciously in 2013, we were backing off a little bit to go more even flow so that we were not preselling lots to builders who were going to participate in the upside, but I think we're really just showing a natural progression as we go along. We could accelerate some of those if we felt it was appropriate, if we get the re-entitlement side of things done in time and that goes region by region. Austin is a prime example of that, where we've been hoping to bring those projects on. We have two of them anticipated coming in, one in Q2 of this year and the other one is moving closer to the back end of the year, with respect to that, but there's still some re-entitlement going through on that process just to get it to that point where we can service and sell.

SCOTT SCHRIER:

Great, thank you. From an absorption standpoint, it looks like the absorption rate you're assuming in 2014 might be a little lower year-on-year. Is that true and, you know, what kind of absorption rate are you assuming as we enter 2014 and will that kind of accelerate?

CRAIG LAURIE:

This is Craig. I would say that, you know, we would assume our normal absorption rate is consistent with what we had in 2013. I think probably why you raise that point is we obviously show an increase in the community count, from 47 to net 57. A lot of those new communities start to come on towards the end of the year and I think that probably what is distorting your number somewhat.

SCOTT SCHRIER:

Great. Thanks, Craig. Good luck in 2014, guys.

ALAN NORRIS:

Thank you.

OPERATOR:

As a reminder, anyone who wishes to ask a question may press star and one on your touchtone phone. The next question is from Frank Mayer of Vision Capital. Please go ahead.

FRANK MAYER:

Good morning, guys, and congratulations on the fine year.

ALAN NORRIS:

Thanks, Frank.

FRANK MAYER:

You indicated that you purchased a whole bunch of land last year, $358 million, of which the majority was in Canada. Could you give us some colour on what was purchased and what holes they filled in terms of the scheduling of development and so on?

ALAN NORRIS:

I think it was about equal between Canada and the US, Frank, so it's roughly half and half. I'm just trying to remember specifically; I mean, a number of them would have been some continuing to fill the pipeline in Ontario and I'm just trying to think back. We did a few more deals in Northern California, some shorter term deals up in the Bay area. I don't have the list right in front of me, but nothing of any major consequence. We did some medium-term stuff in Alberta; some outlying areas just outside of Calgary, for instance but nothing that just jumps out as a major sort of one-off or anything like that, but just a number of different small pieces.

ALAN NORRIS:

I can try and give you a better sense of that later on. I mean, I just don't have it at the top of my head right now.

FRANK MAYER:

That would be helpful. With regard to the increase in the cash flow to $5.5 billion from roughly the $5 billion level, how did you deal with the exchange rate fluctuations in the course of 2013? In other words, was the $5.5 billion, would it have been greater if the Canadian dollar hadn't come down during the course of the year?

ALAN NORRIS:

Yes, I think it was. $0.95 we used; is that right Craig?

CRAIG LAURIE:

Yes, Frank, it's Craig. We assume, obviously, in the mid and long-term perspective, par for the dollar. We assume really, past the next year or two, that we have par for the Canadian/U.S. dollar.

FRANK MAYER:

You assume par?

ALAN NORRIS:

After the next couple of years.

CRAIG LAURIE:

Yes.

FRANK MAYER

Now, the second question I have regarding the $5.5 billion, clearly, that would throw off a lot of cash flow and earnings to all the investors in your Company. What is deemed to happen to that cash flow in this model, in this calculation? In other words, is it paid out, is it reinvested, does it sit there sterile, does it…

ALAN NORRIS:

…yes, that number, for purposes, is really just showing a static cash flow kicks off of the existing assets that we own at this point in time. Obviously, as we go forward, we would be reinvesting or distributing, looking at all the various options with respect to that cash flow as we go forward. It's not meant to be a live document that way.

FRANK MAYER:

So, in other words, that's an extremely conservative cash flow on the premise that management is capable of reinvesting whatever portion of the funds it chooses not to distribute to the investors, that number could be enhanced in the future.

ALAN NORRIS:

Yes, it's just intended to show what cash flow would kick off of existing assets, that's really all, and you're exactly right.

FRANK MAYER:

I understand. Thank you very much.

ALAN NORRIS:

Thanks, Frank.

OPERATOR:

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

ALAN NORRIS:

Thank you. So, thanks very much for dialing in to our year-end earnings call. At this time, we'd like to thank all our shareholders for your confidence and support in our Company and we look forward to building on our 2013 results and continuing to reward your investment in us in the coming years. So, thank you very much, indeed.

OPERATOR:

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