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EDITED TRANSCRIPT

TOL - Q1 2018 Toll Brothers Inc Earnings Call

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OVERVIEW:

Co. reported 1Q18 EPS of \$0.83.



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PRESENTATION

Operator

Good morning, everyone, and welcome to the Toll Brothers First Quarter 2018 Earnings Conference Call. (Operator Instructions) Please also note, today's event is being recorded.

At this time, I'd like to turn the conference call over to Mr. Doug Yearley, Chief Executive Officer. Sir, please go ahead.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Thank you, Jamie. Welcome, and thank you for joining us. I'm Doug Yearley, CEO. With me today are Bob Toll, Executive Chairman; Rick Hartman, President, COO; Marty Connor, Chief Financial Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Kira Sterling, Chief Marketing Officer; Mike Snyder, Chief Planning Officer; Gregg Ziegler, Senior VP and Treasurer; and Don Salmon, President of TBI Mortgage Company.



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Before I begin, I ask you to read the statement on forward-looking information in today's release and on our website. I caution you that many statements on this call are forward-looking based on assumptions about the economy, world events, housing and financial markets and many other factors beyond our control that could significantly affect future results. Those listening on the Web can e-mail questions to rtoll@tollbrothers.com.

We completed fiscal year 2018's first quarter on January 31. We are very pleased with our first quarter results across all metrics as our revenues, contracts, backlog, earnings and profit margin met or exceeded our expectations. Demand remained very strong with contracts in dollars increasing 36% in the first quarter. We saw a significant acceleration in contracts per community this quarter compared to 1 year ago on annualized pace of 24 sales per community, up from 19 in last year's first quarter. Even so, we have yet to reach our historical norms of annualized contracts per community in the high 20s.

The California and Western regions led the way with 93% and 36% growth, respectively, in the value of contracts signed compared to 1 year ago. The South was up 17% and the North was up 15%. Only in the Mid-Atlantic did we see a decline.

City Living, which is primarily in Metro New York City, saw growth with the value of contracts in our wholly-owned projects up 25%, led by 10 Provost Street, our Jersey City for sale high-rise condo community located 1 block from the Grove Street PATH Station. This 28-story high rise containing 242 residences has taken 120 agreements since opening last summer at an average price of \$800,000.

Our contracts in joint ventured City Living high-rise projects also rose, driven by 91 Leonard, our 111-unit condo building located in Tribeca, which sold 50 units in Q1. As previously guided, we had an expected dip in community count in the first quarter, which will continue in the second quarter. This should reverse in the back half of the fiscal year as we anticipate opening approximately 70 communities during the third and fourth quarters of fiscal year 2018, offset in part by the closing out of some existing communities. Net-net, this should translate to community count growth at the end of fiscal year 2018 compared to fiscal year-end 2017.

Across the U.S., new homes are commanding a 30% premium to used homes. This confirms our belief that more and more buyers are attracted to new versus used homes.

According to the U.S. Census, the average age of the U.S. housing stock is now 37 years compared to 23 years in 1985. Used homes are simply outdated and showing their age more now than ever. Our new home floor plans are much more open and designed for today's lifestyle. Our finishes are more sophisticated. The indoor-outdoor living is spectacular, and the construction is much more environmentally sensitive and energy-efficient.

We see the same preferences for new in our rental project. Our new stabilized rental apartments are over 95% leased. We are monetizing some of the value we have created in our rental business as we generate profits by periodically refinancing or selectively selling assets once they have achieved stabilized occupancy.

As our pipeline of stabilized projects grows, we expect to continue to generate additional earnings from our Toll Brothers Apartment Living assets. We currently have a pipeline of over 14,000 rental units in projects completed, in construction, under development or in approvals.

Shifting gears, we recognize that investors are interested in the impact of tax reform and rising mortgage rates on demand. We canvass our salespeople every week to learn what issues are of concern to our customers. Changes in state and local tax deductions, commonly referred to as SALT, and the mortgage interest deduction are not being mentioned by our buyers, even in high tax states like California, New Jersey and New York.

As I mentioned, California contracts are up 93% in dollars this quarter over last year.

With respect to the mortgage interest deduction, we have previously mentioned that 20% of our buyers pay cash. That number rose to 24% this quarter. Our average buyer who does take a mortgage puts up 30% equity. With an average home in backlog of \$892,000, that is a mortgage of \$625,000, well below the new \$750,000 limit for mortgage interest deduction.



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Recall that the tax reform provisions were known in early to mid-December, but our buyers didn't seem to blink. In comparison to a year ago, contracts improved each month. November was up 16% in units, December was up 20% and January was up 21%.

With respect to interest rates more broadly, in past cycles, we haven't seen much correlation between demand and interest rates as long as rates move -- as long as rate moves are gradual and in tandem with an improving economy. With the economy strong, the unemployment rate low, the stock market healthy and a shortage of supply of new homes, we believe that gradually rising interest rates tied to a strengthening economy will not upset demand.

Note that the average 30-year fixed rate is 4.5% today, and a year ago, it was 4 3/8%. As we have said many times, we would rather have a 5% mortgage rate in a booming economy than a 3.5% to 4% mortgage rate in a weak economy. We continue to believe and our results appear to confirm that our buyers are less impacted by rising rates.

Now let me turn it over to Marty.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Thanks, Doug.

Before I address the specifics of this quarter, I do want to note that a reconciliation of the non-GAAP measures referenced during today's discussion to their comparable GAAP measures can be found in the back of today's press release.

Q1 was a very strong quarter for us. Compared to a year ago, revenue grew 28% and gross margin held steady, despite continued pressure from labor, material and land input costs. Gross margin actually came in better than expected, while average price came in slightly lower, all due to small changes in our mix.

As a percentage of revenue, SG&A was better by 150 basis points and operating income improved 160 basis points compared to a year ago. On a dollar basis, operating income grew from \$50.6 million last year to \$83.7 million this year, which is a 65% improvement.

Below the operating income line, we continue to demonstrate our ability to generate earnings from various sources in our JV and other income line items.

Last year, much of our below-the-line earnings came from JV condo unit deliveries in our New York City living product. So far, this year, the majority comes from a \$30 million gain from the disposition of our 1,500-bed student housing property at the University of Maryland. This gain was on a \$12 million equity investment, and our IRR was nearly 50%. This shows an example of why we really like the rental business. We will continue to hold some apartment properties long term, while selling others as we balance building a long-term portfolio with producing current earnings.

Further down the income statement, we showed a one-time benefit from the decrease in the federal corporate tax rate associated with tax reform. Through some strategic tax planning, we ended last fiscal year with a net deferred tax liability, and when tax reform passed in December, this generated a \$31.2 million revaluation gain. Longer term, we will obviously benefit significantly from the lowering of the corporate tax rate and look forward to future years, meaning 2019 and beyond, where our effective tax rate will be approximately 26% to 27%.

Essentially, post tax reform, we will retain approximately \$0.10 more of every dollar of pretax profit.

During the quarter, we repurchased approximately 4.4 million shares at an average price of \$47.43. Our weighted average share count at the end of 2017's first quarter was 170.4 million shares. This quarter end, it had dropped to 158.9 million shares, a 6.7% reduction. Add all this up, and our earnings per share nearly doubled to \$0.83 from \$0.42 per share last year.

So far, in the second quarter, we have repurchased an additional 1.4 million shares at an average price of \$46.07.



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Looking forward to the balance of the year and subject to our normal caveats, we offer the following guidance: full fiscal year 2018 deliveries of between 7,800 and 8,600 units with an average price of between \$820,000 and \$860,000; second quarter deliveries of between 1,825 and 1,925 units with an average price of between \$825,000 and \$850,000; full fiscal year '18 adjusted gross margin, that's pre-interest and pre-impairments, should be between 23.75% and 24.25% of revenues, with second quarter adjusted gross margin of approximately 22.8%; full fiscal year SG&A as a percentage of fiscal year revenues -- full fiscal year revenues should be approximately 10%, with second quarter SG&A, again, as a percentage of second quarter revenues of approximately 10.6%; for the full year, our other income and income from unconsolidated entities should be between \$130 million and \$170 million, with approximately \$15 million occurring in our second quarter; our full fiscal year tax rate should be between 23% and 25%, with a second quarter tax rate of approximately 27.5%.

And one last note, in January, we issued \$400 million of 4.35% senior notes due 2028. This is the lowest interest rate the company has ever paid for a 10-year bond.

Now let me turn it over to Bob.

Robert I. Toll - *Toll Brothers, Inc. - Executive Chairman of the Board*

Thank you, Marty.

The new home industry appears to be building momentum with the national homeownership rate rising over the past year. Wages are increasing. Home equity is building. Consumer confidence is strong. The economy is improving and demand for housing is accelerating. Meanwhile, the supply of new homes is in short supply as production lags demand in many markets. These trends indicate positive landscape for the new home market and particularly for Toll Brothers in the coming years.

And now, back to you, Doug.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Thank you, Bob. Thank you, Marty.

The quality of our homes and our brand were recently recognized by a number of business and industry leaders. In January, we were named by Fortune Magazine as the World's Most Admired Home Building Company for the fourth consecutive year. Toll Brothers homes, communities, design studios and teams across the country were also recently recognized with 40 national awards by the National Association of Homebuilders, Pacific Coast Builders Conference and others. This includes our Sullivan model at Adero Canyon in Arizona, which was named National House of the Year at the PCBC Gold Nugget Awards. It's the home on the cover of our new 2017 annual report.

These honors reflect a tremendous effort and commitment to excellence of the entire Toll Brothers team and our focus on providing our homebuyers and renters with the highest levels of quality, value and service. We salute them and thank them for their amazing hard work.

Based on our great brand, strong first quarter backlog, healthy demand and our well-located land positions for future expansion, we believe fiscal year 2018 will be another year of growth for Toll Brothers.

Now let's open it up for questions.



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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question today comes from Stephen East from Wells Fargo.

Stephen F. East - Wells Fargo Securities, LLC, Research Division - Senior Analyst

Doug, I walked the Sullivan. And to steal your phrase, it was spectacular, that's for sure. Start with the share repurchase, I know you all are opportunistic on it, but is there some level of repurchase that you're comfortable with or that you really probably want to achieve? And I'm thinking about what type of cash you have available? What type of debt level you have there and maybe what we could expect this year and next year?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

Stephen, I think, we are both opportunistic and strategic in our repurchases. I think, as we went through the first couple of months of this year, we got optimistic that tax reform would pass and that we did not believe the full effect of that was reflected in our share price. We have plans for further repurchases should opportunities present themselves through the balance of the year, but I don't think we're going to give a specific targeted number at this point.

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

Right. In the past, Stephen, you'll recall, we had guided that we thought we'd probably spend about \$400 million per year, and that's not set in stone, but that's certainly a number that we've had in mind. And as you can see from our activity recently, we've done a bit more than what I'd call \$100 million a quarter to add up to that \$400 million, for the reasons that Marty gave.

Stephen F. East - Wells Fargo Securities, LLC, Research Division - Senior Analyst

All right. Fair enough. And then, turning to orders, you all continue to post very strong numbers there. California is really strong. And I guess, you can talk a little bit, I know there's good demand there and lack of inventory, but maybe a little bit more specifically what some of the drivers are and how you all feel about the sustainability? And I know I've asked this before, but is there just not much price ability in that market? I know you take some, but do you rapidly hit a ceiling with that? Could you not push pricing more or do something to slow down that pace? And then, just in the Mid-Atlantic, what's happening there?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

Sure. So we'll start with California. Obviously, business is fantastic out there, as reflected by the numbers this quarter. I know you travel a lot, Stephen, and you've seen it and has impressed you where -- with the Sullivan model in Phoenix what we are doing in both Northern and Southern California is that same word, spectacular. We have distinguished ourselves with our communities, with our architecture, with the ability to go to our design studios and really create a custom home. And it's really paying off. The markets are very strong. Northern California was led by the grand opening of a new community in Fremont, right next to the new Bart Station and the Tesla facility called Metro Crossing. We've sold 53 units north of \$1 million in the last 2 months with our grand opening in the Metro Crossing. So that was certainly the #1 driver in Northern Cal. And in Southern Cal, it continues to be Orange County where we just have seen fantastic results. The market is very strong. Job growth is in place. It's a very diversified economy. And with respect to pricing, we continue to have significant pricing power in both Northern and Southern California. We raise prices regularly. We also keep an eye on, obviously, growing backlog and how quickly we can turn houses. And for as big as our backlogs are in California and as expensive and complicated as our houses are, we are able to build those houses faster than in many other parts of the country. So the trade base is in place and we are continuing to manage pricing with the size of the backlog. Right now, it's in balance, and I'm just thrilled with where we're positioned. And I see a very bright future going forward in California. We also have some very exciting new land deals that we're working on. So all is good out West. With respect to the Mid-Atlantic, it was our only area that, as I mentioned, was down in sales, and it was driven by fewer

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sales in Northern Virginia, which is our biggest Mid-Atlantic market. And we think Northern Virginia was down in the first quarter for 2 reasons. The first is that we had lower community count as we are in between phases in a few of our large master plan communities. And the second reason, we believe, is due to the uncertainty associated with the federal government budgetary debates that occurred in December and January. And of course, while these debates were national news, they had a more direct impact on the local Northern Virginia buyer.

Operator

Our next question comes from Michael Rehaut from JPMorgan Securities.

Michael Jason Rehaut - JP Morgan Chase & Co, Research Division - Senior Analyst

First question, you pointed in your prepared remarks, Doug, to the strong improvement in sales pace, and it certainly was impressive with over 20% gain. At the same time, you talked about more upside as you turn to normalized paces, but I was hoping when you kind of look at that improvement in sales pace, which markets led that or which regions led that improvement? And how should we think about the balance of the year? You have slightly tougher comps if you back against in terms of the year ago growth, but nothing too dramatic. I mean, should we be expecting a strong double-digit sales pace improvement for the rest of the year? Or how should we think about that?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

Mike, I'll be happy to give you our top markets for sales. As you know, we don't pull the crystal ball out of the closet and predict where sales may be for the balance of the year. I'll just maintain what I've said, which is I'm thrilled with where we're positioned and how well we're doing. And I'm also excited that in the second half of the year, we have, as I said, about 70 new communities opening. But with respect to individual markets, the #1 market for sales per community for the quarter was Northern California at 13.1 sales. And I'll remind you that November, December, January are not the strongest 3 months of the year. So you can probably multiply that 13.1 by a little more than a factor of 4 to come up with an idea of an annualized number just because of the timing of Q1. Market #2 would be New York City at 12.6 contracts per community. Market #3 would be Reno at 9. Market #4 would be Boise, Idaho at 8.7, followed by #5 would be Southern Cal at 8 sales per community. And by the way, Southern Cal had an average price of \$1.9 million. And then, #6 is Orlando at 7.2 sales. #7 is Massachusetts at 7. #8 is Austin, Texas at 6.8. #9 is New Jersey at 6.6. And rounding out the top 10 would be Vegas at 6.4.

Michael Jason Rehaut - JP Morgan Chase & Co, Research Division - Senior Analyst

That was very helpful, Doug. Obviously appreciate all the regional color...

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

That's as close as we're going to get to Bob Toll's old report card with letter grades.

Michael Jason Rehaut - JP Morgan Chase & Co, Research Division - Senior Analyst

That's right. I remember that fondly. Second question, just a little clarification, if possible. When you talked about the community count, your comments around that, you said that 2Q should still be down, but by the end of the year, it should be up. I just wanted to make sure I understood correctly. 2Q down further sequentially or just more continue to be down year-over-year? And talking about the year-end growth, are we talking about low-single digits, mid-single digits? And then, just finally, if I could sneak another one in there, Marty, if you could just -- tax rate for next year, I just want to make sure I heard that right, I think you said 26% to 27%?



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Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I did. I got mine done, Doug. Now it's your turn.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Marty's answer is yes. That's what he said. Q2 was down sequentially. And year-end community count over '17 year-end, we're maintaining the guidance we gave last quarter, which was up similar to the prior year, which was in the range of 5% to 10%.

Operator

Our next question comes from John Lovallo from Bank of America Merrill Lynch.

John Lovallo - *BofA Merrill Lynch, Research Division - VP*

I guess, the first question would be on raw materials, particularly lumber. I mean, there's been some notable increases there. I mean, how are you guys thinking about raw materials in general and lumber specifically as we head through the year?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

So lumber was up about \$2,000 this quarter. Remember, it's the largest component of our materials in a home. It was driven by New Jersey, Pennsylvania, Dallas, Houston and Colorado. Thankfully, labor, while we still have labor issues in many markets, those increases have moderated. So overall, our building costs are up modestly and it's pretty much all driven by that increase I mentioned in number. When you look at the cost [increases] to build a home, 55% of our cost [increases] to build a home is lumber, 32% is other materials that go in a home and 13% is labor (corrected by company after the call). So for the most part, the 13% labor and the 32% other materials are relatively stable, but the lumber component has gone up. So overall, we've seen a modest increase in the cost to build a house the last quarter.

John Lovallo - *BofA Merrill Lynch, Research Division - VP*

That's helpful. And then, last quarter, I think, there were some discussion around maybe an appetite for creating or buying some kind of off balance sheet land entity, any -- is there update on that?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

No. Not at the moment.

Operator

Our next question comes from Megan McGrath from MKM Partners.

Megan Talbott McGrath - *MKM Partners LLC - MD & Co-Director of Research*

I wanted to ask a little bit about the guidance, specifically on the gross margin into the second quarter. Obviously, seeing a sequential decline there. Could you just talk us through what kind of mixed things you're seeing into next quarter and then your confidence that, that reverses into the back half of the year as you've maintained your full year guidance?



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Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Sure. I think, it's a function of mix. I think, we have a little less positive margin coming out of our Hoboken project, 1400 Hudson as the number of units left there has decreased significantly. And then, we expect a few communities out in the West to have slightly lower margin than the communities they replaced, namely our great Baker Ranch and Hidden Canyon communities. We are [out of Schlitz], as Mr. Toll likes to say. And so we have replacement land that we're building on that has great margins but not quite as great.

Megan Talbott McGrath - *MKM Partners LLC - MD & Co-Director of Research*

And then, Marty, that kind of reverses in the back half? What shifts into the back half of the year for those better margins?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

So I think we continue to see more volume coming out of California, which as a percentage of total has -- influences the margin positively. We continue to see improvement in margin in some of our newer regions like Seattle and Boise and general mix issues all around the country that give us confidence in the guidance we've given.

Operator

Our next question comes from Alan Ratner from Zelman & Associates.

Alan S. Ratner - *Zelman & Associates LLC - Director*

Doug, the commentary you had on what you're seeing from the field on rates was very helpful. I know you're not obviously very exposed to the entry level. But was just curious, are you seeing any differences in that feedback across your maybe T Select product or some of the markets where you do have a bit lower of an average price, maybe like a Boise where, certainly, the price runs below the company average? Or are those comments pretty consistent across all your various price points?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Alan, the comments are pretty consistent across all of our markets and price points.

Alan S. Ratner - *Zelman & Associates LLC - Director*

Okay. And then, just as far as February, I know you don't give the nonbinding deposits anymore, but should we take from your comments that you're not seeing the market change in conditions thus far in the month?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Yes. As you recall, a few quarters ago, we got out of the business, of talking 3 or 4 weeks worth of deposits in agreements because we recognize it was not predictive of the full quarter. And so we're going to continue to stay out of that business. We think it's the smart way to go. All I'll say is that our business continues to be good.



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Alan S. Ratner - *Zelman & Associates LLC - Director*

Okay. If I could squeeze in one last one, just on California. So Marty, you've highlighted obviously the impact from the community shift there as you close out some of the communities with great margins, but should we think about maybe the longer term just given how strong sales pace is there. When does that fully mix out? Meaning, when should we think about kind of the new normal, if you will, should -- in the beginning of '19, should we start to see that reflect more of a consistent margin with what you're currently underwriting and opening communities at?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

So I think our margin in California is going to be in the upper 20s this year, as we guided, and it was the low 30s last year. We're not prepared to update margin guidance beyond 2018.

Operator

Our next question comes from Jack Micenko from SIG.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

Marty, wondering how you're thinking about ROE targets now going forward? The one -- first quarter demand was a bit better, you put your foot on the gas on the buyback a bit. Any numbers you can point to into the end of the year on where you think you can get ROE to?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Well, I think, we ended last year with a return on beginning of the year equity at around 12.7%. Our press release mentioned that we expect this year to be up 300 basis points on top of that. And we'll get to 2019 when we get to the end of 2018.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

Okay. Fair enough. And Doug, are you starting to see any migration towards adjustable rate to ARM loans over the quarter? And if so, is there a sweet spot that, and I don't know, 5.1%, 7.1%, 10%, that anybody -- the borrower profile is sort of aligning to based on the moving rates?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Not really. For the first quarter, 79% of our loans were fixed rate, 21% were ARMs. All of 2017, 78% were fixed rate, 22% ARMs. So we're not seeing a lot of movement there at all.

Operator

Our next question comes from Nishu Sood from Deutsche Bank.

Nishu Sood - *Deutsche Bank AG, Research Division - Director*

So I wanted to come back to the absorptions. Obviously, fantastic trend there stretching back quite away. Doug, you were throwing around the concept of we're not back to normalized yet. The first quarter run rate, as you know, 24-ish, and long term, it's 27-ish. I just wanted to dig into that a little bit. Obviously, the first quarter, and you mentioned this when you're talking about Northern California, the first quarter is the seasonally low period, so that translates to, I think, a little bit higher on a run rate. Your geographic mix is quite different than what you might have looked at for



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the normalized period. And your rundown of the top 10, I think, 8 of the top 10 were in the South and West, so some of the more recent markets. Obviously, townhomes and active-adults are a bigger proportion than they used to be. So when you factor all that, like what's possible here? You've had a tremendous run. Trying to think about how far it might go.

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

Nishu, it's a great question. We've talked about it before that what is the new norm because we have a different geography, we have more attached product that sells at a higher pace. We obviously have City Living that can sell at a much higher place. Active-adult tends to sell at a higher pace. Boise, other Western markets have sold at a higher pace. So recognize that, that historic number back to the, call it, the early 2000s, was made up of a -- was a different business model than we have today. And we can't exactly quantify what that new norm would be, but it is certainly north of the old norm. We think it's probably north of 30.

Nishu Sood - Deutsche Bank AG, Research Division - Director

Got it. Okay. That's very helpful. And then, the sale of the student housing complex, obviously, fantastic for returns. You have obviously been more focused on returns in recent years. What was the trigger of that? Was it something specific? Obviously, there's been a tremendous appetite for student housing projects. So was that the trigger? Was it returns-driven? And really, obviously, thinking here about how many other opportunities like there -- on this balance sheet and that under the new kind of returns-focused approach you're taking here, how many more of these could we see, I guess, is where I'm headed with that?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

So Nishu, it's Marty. Much of the decision to sell that project was driven by our partner who is even more focused on returns as an investment fund than we are. And when we saw the price that was available to us, we certainly concurred. The timing during the year is important on the sale of that nature as well. And remember, these buildings are fully leased by August or not. And this one was fully leased by June or July, and we're able to execute a transaction that closed in November. So we took any uncertainty about re-leasing off the table in that pricing.

Our apartment business by its very nature is setting up further opportunities to monetize some buildings. Our mentality is going to be along the lines of build 3, hold 2, sell 1, so that we can get more routine in the triggering of these sorts of gains, maybe not at this particular magnitude because this was a very sizable asset. But you saw us monetize a couple assets last year. We took care of one here in the first quarter, and we have a few more that are embedded in our guidance for the balance of the year.

Nishu Sood - Deutsche Bank AG, Research Division - Director

The apartment pipeline, as you build it, is going to be a drag on returns because, obviously, just because of the funnel nature of it and, at some stage, it turns, returns accretive when you get to the steadier state, as you were saying, monetize 2 and hold 1. So where are we in that process of building a pipeline and the overall pipeline, the overall business becoming returns accretive.

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

Sure. And I think it's important to address the first part of your comment to mention that, generally, we're 25% partners in these deals. In some cases, we've been as much as 50%. When we are 50%, that gives us the opportunity to kind of half sell or sell down like we did with our first 2 buildings. But we think, this building, this project is excellent. We get project-level financing on these off balance sheet structures, essentially replacing equity with, call it, 4% debt for 2/3 of the cost. Our investment in this business is roughly \$0.25 billion on a \$10 billion balance sheet. So while it may, from time to time, appear to be a drag on earnings, we think, over the long haul and within each year, it is going to be positive. We have 14,000 apartments in various stages of development, call them roughly 300 units each. So it's in the neighborhood of 45, 50 projects that as we get this engine going, and I think we're a couple of years away from being as routine in it as we'd like to be, we can trigger some gains.



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Robert I. Toll - *Toll Brothers, Inc. - Executive Chairman of the Board*

Excuse me. It was the reverse, we're holding 2, selling 1.

Kira Sterling - *Toll Brothers, Inc. - CMO*

2.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I'm sorry, did I say it wrong?

Kira Sterling - *Toll Brothers, Inc. - CMO*

No, he did.

Robert I. Toll - *Toll Brothers, Inc. - Executive Chairman of the Board*

No. The questioner reversed himself.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Okay. Fine. Yes. Build 3, hold 2, sell 1.

Robert I. Toll - *Toll Brothers, Inc. - Executive Chairman of the Board*

Now you got it.

Operator

Our next question comes from Mike Dahl from Barclays.

Michael Glaser Dahl - *Barclays Bank PLC, Research Division - Research Analyst*

I had a follow-up to -- of sorts on the return question. And if I'm thinking specifically about the City Living business, at least at the time of your last profile, it looks like there's no buildings under construction or that start construction beyond Q4 of 2018. So could you just give us an update in terms of kind of what you're seeing in the market for new projects and how you're thinking about kind of beyond, in the next couple of quarters or this next wave of buildings, the owned versus JV side of it?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Sure. So our future pipeline beyond the Q4 '18 that you referenced include another tower in Jersey City, 2 more buildings in Hoboken, 1 building in SoHo, Manhattan and another building north of Hoboken and Weehawken. We have 3 properties under contract in Los Angeles to expand City Living to the West Coast, in great locations like Beverly Hills that we're very excited about. We have another opportunity that we're recently playing with and going under contract for in Philadelphia. And so -- and we're looking hard in Manhattan and Brooklyn. There's nothing new to report at



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the moment, but the deal flow is picking up a bit as the sellers become more realistic in the value of their asset. So we're in good shape. It needs to grow. It will grow. But I'm happy with those half a dozen or so that I just mentioned with, I believe, more to follow.

Michael Glaser Dahl - *Barclays Bank PLC, Research Division - Research Analyst*

That's helpful. And then, I guess, a two-part follow-up, if I could. First, is there any way you can give us a sense of kind of size and timing for those L.A. opportunities? And the second is from a competitive standpoint, on one hand, you have the sellers adjusting, and then, on the other hand, presumably, bank financing to some of your would-be competitors for those deals would appear to be getting tighter, I think. So can you just give us a little more color on the competitive environment as you've been bidding out some of those?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Sure. I'll talk about L.A. for you and then Marty can take over on the financing side. The 3 properties in Los Angeles are small. They are boutique, infill, mid-rise condo buildings. We're not targeting downtown L.A. We're targeting the pockets around L.A., like Beverly Hills, Newport Beach, Santa Monica, Pasadena, places like that. And they are all -- they will all come online, or at least construction will commence, within the next year to 2. And then, Marty, on the financing side?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Sure. I think, you're right, Michael, that financing has gotten more challenging, particularly for other players in the industry. We continue to have great relationships with our banks, both on our apartment financings as well as our condo financings. And I've actually seen rates come in a bit in some quotes on the apartment business. We haven't been as active in the market for condo financing recently for me to give you a current assessment of that, but it's definitely harder for our competition to find some financing.

Operator

Our next question comes from Susan Maklari from Crédit Suisse.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

You've seen some nice lift in the SG&A this quarter, and it looks like you expect that to somewhat continue in the second quarter. Can you just talk a little bit about longer term, how -- what the potential is there? How we should think about it coming from just an improving top line relative to maybe some of the things you can actually do from an underlying cost perspective?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Sure. So our guidance for the year is it remains at 10%. We continue to make progress there, 10% is near an all-time low for us. We continue to see some advances in technology as it relates to the systems we're putting in place. They have not yet begun to pay dividends. Our teams are working very hard. And I think, while we would hope to get further improvement as years progress, we're going to stick with this year's guidance.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then, maybe you could give us a little bit more color on the T Select product. I know that you said that in terms of the -- some of the feedback you've gotten, it's been consistent with your other business. But as we sort of think about this coming together more and you're just getting a little bit more experience with it, how is the rollout progressing? Are you thinking about taking it to even further markets or just where do things stand?



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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

We are definitely taking it to further markets. Right now, it's in Texas, Florida and Pennsylvania. Strategically, we wanted to roll it out slowly. As I've talked about on prior calls, we need to fully integrate T Select with a larger luxury brand of Toll Brothers, and it will -- you will continue to see a slow rollout. There are -- there will be many cases where we will not be branding communities T Select, but we will just be selling Toll Brothers houses at a lower price, again, targeting the more affluent millennial buyer who is buying their first home at 37 years old instead of 27 years old when they're wealthier. And so that strategy, whether it be what we already do in Boise or what we already do in Jacksonville or Michigan, Ann Arbor, Michigan as examples, is a continued focus by the company on having a product line that will be appropriate and desirable to the affluent millennial. And so that, in some cases, will be through a T Select brand, and in other cases, will just be just through the Toll Brothers banner. And I'm comfortable with the rollout. I do want to see it accelerate. We have our land teams and our division leadership teams focused on finding more and more opportunities for millennial housing. And I think you'll see more of it over the coming years.

Operator

Our next question comes from Dan Oppenheim from UBS.

Daniel Mark Oppenheim - *UBS Investment Bank, Research Division - Housing and Building Products Analyst*

You talked about bringing on 70 new communities later in the year. Given the way that you're working through them or selling through them so rapidly out here in the West with 13 sales per community in North Cal and the 8 in SoCal, what's the outlook in terms of the representation in those 70 of communities here in California?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Dan, hold on one second. Okay. So we ended the first quarter in California with 41 selling communities. And between new openings and sellouts, we believe, right now, that we will end the year at 42.

Daniel Mark Oppenheim - *UBS Investment Bank, Research Division - Housing and Building Products Analyst*

Got it. Okay. And then, I guess, along those lines then, so presumably, with the 53 sales you had in 3 months and the last 2 months, you're talking about having pricing power, but I guess, you're assuming that higher pace of absorption in these community count plans, so there seems to be sort of more of an active choice for absorption given that California margins are higher than other regions. Is that sort of the overall thought of it? Or how are you looking at it?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Back to my early comments that we are very happy with the ability of our California teams to build houses quickly and efficiently, notwithstanding the large backlogs, so we will continue to raise price, and hopefully, as in the past, the market will continue to buy. We have huge pent-up demand. We have communities where we have hundreds of people who have already filled out mortgage prequalifications and are waiting for the next phase of homes to be opened, so we can call them and say, it's your lucky day. And when they come in, the price is higher than it was a month before. And so long as we can keep building the houses as efficiently as we've been able to, I think, that model is going to work beautifully. And you're right, there's more margin coming out of California. So that is all good news.

Operator

Our next question comes from Ken Zener from KeyBanc.



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Kenneth Robinson Zener - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

So big in California. The demand, we see it, we think it's more stable. I'm going to focus on with California being about 35% of your EBIT and about 33% of your assets, so fairly well-positioned, how do you think about land purchase? Obviously, Shapell was very important to you guys. I think, you've, by and large, gone through a lot of those assets already, so you improved the turns there. But how do you avoid kind of, given the price tag of land out here and the contribution to EBIT, how do you kind of avoid the big surprises if and when -- whenever the cycle turns? I was just thinking of Surprise in 2000 -- Surprise, Arizona where you guys went really long land. I mean, how do you think you'll position asset exposure differently in terms of large communities, given the West, or specifically California's contribution and high cost? I mean, do you guys just do smaller communities now?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Well, smaller compared to Shapell. Absolutely. The land is expensive in California. And my answer is we're keeping a very close eye on the market. We're in touch with sales teams weekly, the nature of the buyer, are there investors coming in, are there -- the vans full of multiple family, friends and families that want to come live together, these are all the things that we are aware of from the mid-2000s when we had issues in a number of markets. Main and Main is the key. We're buying land in the right locations. We're being very careful on how we structure land buys. If a deal gets too big and too expensive, we're not afraid to bring another builder in, we're not afraid to bring a joint venture partner in. This past quarter, we spent \$327 million on land, and \$210 million of that \$327 million was in California. One spectacular piece with Pacific Ocean views on Orange County and another piece up in the East Bay of San Francisco. So I'm very comfortable with our business in California, and I'm very comfortable with how we're buying land. We will continue to be careful. We are doing smaller deals, but they're still very expensive. It's the nature of the market. Our average house, as I mentioned, in Southern Cal is \$1.9 million. Our average house in Northern Cal is \$1.6 million, and that, of course, drives pretty expensive land. But right now, the market fundamentals appear to be very solid.

Operator

Our next question comes from Jade Rahmani from KBW.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Just a couple of quick ones. The lumber, \$2,000 this quarter, was that relative to the home on a per home basis? What's the relative comparison?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

Yes, per home.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. And what was the percentage increase, say, over last year that, that represents?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

The same \$2,000 it's been each of the previous 2 quarters, right?



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Gregg L. Ziegler - *Toll Brothers, Inc. - Senior VP & Treasurer*

That's right? So we're kind of keeping pace with that number every quarter.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. And on the share count, do you have a quarter-end share count?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I'm sorry, Jade, could you repeat the question?

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Yes. Do you have share count at quarter end? Was it around 148.8 million or so?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

158.8 million.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

That's diluted share count, right?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Yes.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

Okay. Do you have the basic share count at quarter end, not the average, but the period end?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I do not have that. Do you have it, Gregg?

Gregg L. Ziegler - *Toll Brothers, Inc. - Senior VP & Treasurer*

If you're asking for the actual share count per book value per share, it was 153.6 million shares.

Operator

Our next question comes from Will Randow from Citi.



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Will Randow - Citigroup Inc, Research Division - Director

Sounds like Don might be there in the background. Hopefully, just curious, with the move in rates, have you seen any change in rate lock activity?

Donald Salmon

We have. We've seen about 10% increase in folks who are locking long term versus a quarter ago.

Will Randow - Citigroup Inc, Research Division - Director

Makes sense. And then, also on underwriting standards, with kind of the puts and takes on SALT versus lower federal rate levels on a personal basis, have you seen any change in the overlays, either you or the banks and correspondents you work with?

Donald Salmon

No, the market really hasn't really reacted to that.

Operator

Our next question comes from James McCanless from Wedbush Securities.

James C McCanless - Wedbush Securities Inc., Research Division - SVP

First question I had is on the adjusted gross margin decline from 1Q to 2Q. Could you guys talk about the catalyst for that? And as part of that discussion, could you maybe talk a little bit about the spread between City Living and traditional homebuilding on gross margin?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

Sure. So the biggest driver of that move in the first quarter to the second quarter is fewer units delivering from the 1400 Hudson project in the City Living Hoboken area. We expect City Living margin for the full 2018 year to be in the 26% to 27% compared to our full midpoint of the company in total of around 24%.

James C McCanless - Wedbush Securities Inc., Research Division - SVP

Okay. Great. And then, on the share repurchase, how much do you have left on that now?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

17.3 million shares left on the authorization that we just put in place in December, mid-December of '17 per our new \$20 million share authorization.

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

20 million shares.



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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Director*

20 million shares. We have 17.3 million shares left under that authorization.

Operator

And ladies and gentlemen, our final question today comes from Mark Weintraub from Buckingham Research.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

A couple of questions on cash flow and use of cash. You mentioned \$327 million of land spend, and I assume that was just land, not development spend in the first quarter '18?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Correct.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Can you -- last year was the first year where inventories were actually a source of cash for quite a while as opposed to a use of cash. Any indication if you notice you expect this year for how that will play out?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Well, I think, we generally do not forecast land purchases. I think, last year, you saw us move the percentage of land owned as a percentage of total down. We've remained at 65% here at quarter end. And we'll see, as the opportunities present themselves to us, whether we're able to move that down any further or not.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. Because obviously, if we see that again as a -- last year, you're also in a position where not only did you do your share repurchase, you had a lot of extra moneys to be paying down debt, et cetera. And so, just -- again, if we're going to have another year where there's not going to be a lot of cash building up inventory, you're going to have a lot of moneys to put the work even beyond the, say, \$400 million share repurchase. Just trying to understand where the thinking might be.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

So I think we're looking at this year, absent a strong uptick in land opportunity, to be modestly cash flow positive. And like in any other year, we'll evaluate the opportunities to reinvest in the business, buy back stock, pay down debt. I think, as we look at our debt right now, our term loan has a little less than 3 years left on it, and that is a variable rate piece of debt. First and foremost, we're going to buy land.

Operator

And ladies and gentlemen, with that, we'll end today's question-and-answer session. I'd like to turn the conference call back over to management for any closing remarks.



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Douglas C. Yearley - Toll Brothers, Inc. - CEO & Director

Jamie, thank you very much. Thanks, everybody, for listening in and joining us this morning. And have a great week.

Operator

And ladies and gentlemen, with that, we'll conclude today's conference call. We do thank you for joining. You may now disconnect your lines.

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