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TOL - Q2 2018 Toll Brothers Inc Earnings Call

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PRESENTATION

Operator

Good morning, and welcome to the Toll Brothers Second Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded.

I would now like to turn the conference over to Douglas Yearley, CEO. Please go ahead, sir.

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

Thank you, Laura. 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.

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 second quarter on April 30. Our double-digit dollar growth in revenues, contract and backlog reflects the health of the luxury new home market. We had another solid spring selling season. The value of second quarter signed contracts, the highest quarter in our history, rose 18% in dollars on a 6% increase in units. On a same-store basis, signed contracts of 9.04 per community were up 16% from last year and the highest for a second quarter since 2005. This was our eighth consecutive quarter of year-over-year same-store contract growth.

Based on our second quarter results and feedback from our sales teams around the country, it does not appear that the rise in mortgage rates has had a negative impact on our business. The 30-year fixed rate mortgage is still only at 4.87%, which is up about 75 basis points in the past year.

We have also not seen any impact from SALT, the changes to the state and local tax deduction on our sales. California, where SALT would be felt the most, was particularly strong this quarter.

For example, in Northern California, Metro Crossing in Fremont has sold 136 homes since opening 3.5 months ago at an average price of $1.2 million. In Southern California, Altair, located in Irvine, has sold 78 homes since February at an average price of $2.5 million.

I also want to highlight some other markets where we have seen strong sales. In Boise, a market that may be perceived as more interest rate-sensitive, we continue to sell very well. For the second quarter, we took 14.5 contracts per community and ended the quarter with 354 homes in backlog.

Our acquisition of Coleman Homes there continues to exceed our expectations.

Active-adult continues to sell well in both the Western markets, such as Reno and Las Vegas, and in the East.

For example, out West, at Regency at the Monty Ranch in Reno, we have sold 35 units since February. And in the East, at Regency at Kimberton Glen, located outside of Philadelphia, we have taken 36 agreements, also since February.

At Coastal Oaks, which is a master-planned community in Jacksonville, Florida, we have sold 42 homes since February.

I am proud of our performance this quarter considering our reduced community count and a difficult comp to last spring.

In 2017, our second quarter contracts were up 23% in dollars and 26% in units from the prior year, and we had 12% more communities last year than this year. Nonetheless, as I mentioned, this quarter we had the highest dollar value of contracts for any quarter in our company's history.

We project third quarter end community count to be approximately 290, down from 312 at last year's third quarter end but up from 283 at 2018's second quarter end. With 75 planned and new community openings in the back half of fiscal year 2018, we project to end fiscal '18 with approximately 315 communities compared to 305 at fiscal year-end 2017.

And without giving specific guidance on community count for fiscal year 2019, we already own or control enough communities we plan to open next fiscal year to project growth in community count, and that is before potential new land acquisitions in the pipeline.

Turning to revenues. We saw a 17% rise this quarter with increases in every region. California revenues rose 17% and was our largest region, producing 27% of total revenues. The North was up 19%, the Mid-Atlantic was up 13%, the South was up 23%, the West was up 15%, and City Living was up 17%. California and the Western region combined produced nearly 50% of total revenues, reflecting the strategic diversification of the company's operations over the past decade.

With our $6.36 billion backlog, we believe fiscal year 2018 will be a year of significant revenue growth. Based on this backlog, a projected increase in community count, the quality of our brand and land portfolio, the financial strength of the affluent homebuyer and the breadth of demographic segments we serve, we believe fiscal year 2019 will be another year of growth as well.

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 release.

We are pleased with our second quarter results. We exceeded the midpoint of our guidance for revenues, units delivered and average delivered price, and we exceeded our specific guidance for SG&A, JV and other income, and our tax rate.

Adjusted gross margin came in a bit lower than the guidance for 3 main reasons: First, we had some delayed high-margin California closings, which we expect to shift into the third quarter; second, we saw the impact of labor and material cost pressures; and the third reason was attributable to our strategy of reducing standing inventory in some of our finished condo projects in New York City.

Related to that, we have made meaningful progress in our previously announced initiative to sell out the remaining inventory in some of our completed condo buildings in New York City.

To date, we have sold approximately 48% of the units and 43% of the dollar value of the wholly-owned inventory we began this fiscal year with. This is a returns-focused initiative that has some short-term impact on margins but will generate significant cash that we can reinvest in better opportunities.

For the full year, we reaffirm our adjusted gross margin guidance at 23.75% to 24.25% of revenues but acknowledge the challenges associated with labor and material cost inflation.

On the other hand, California, which is a higher-margin business, is becoming a larger percentage of deliveries. In Q2, it was 27% of revenues. We expect that to grow steadily through the balance of the year to the mid to low 30s percent of revenue.

It's also important to note that all product types and all regions are projected to show margin improvement in Q3 and Q4.

Consistent with our focus on return on equity and driving shareholder value, over the last few years, we have been reducing the number of years of land we own on balance sheet. It is now below 4 years based on the midpoint of fiscal year 2018's projected deliveries. We will continue to focus on increasing the percentage of land we control through options in order to improve our return on equity.

Also related to return on equity, to date, we have repurchased $291 million worth of our stock since the beginning of the fiscal year and reiterate our soft target of $400 million for the full year.

Finally, in April, we increased our quarterly dividend from $0.08 to $0.11 per share. This returns the dividend yield to approximately 1% of our share price.

Our apartment business continues to grow. We now control a pipeline of approximately 16,000 units in projects completed, in construction, under development or in approvals. We are expanding this operation beyond our Metro Boston to Washington, D.C. base and now have teams in San Fran, Los Angeles, Atlanta, Dallas and Phoenix.

Turning to guidance for the third quarter and the balance of the fiscal year and subject to our normal forward-looking statement caveats, we offer the following guidance. We are increasing the midpoint of our full year delivery guidance by 50 units and $5,000 in average delivered price. That is approximately an $80 million increase to the midpoint of our revenue guidance for full fiscal year 2018. We now expect full year deliveries to be between 8,000 and 8,500 units at an average price between $830,000 and $860,000.

For the third quarter, we expect deliveries between 2,100 and 2,200 units at an average price of between $830,000 and $850,000.

We reaffirm our adjusted gross margin guidance for the full fiscal year of 23.75% to 24.25% of revenues with the third quarter estimated to be around 23.4%. We reaffirm our fiscal year SG&A guidance of 10% of revenues with a rate of 9.6% expected in the third quarter.

We revised the range for our fiscal year JV and other income guidance down slightly to $130 million to $160 million and expect approximately $20 million of this to be in the third quarter. Our effective tax rate guidance is reaffirmed at 23% to 25% for the year, and our expectation for the third quarter is 27.5% of pretax income.

As Doug noted, we project a slight increase in third quarter end community count compared to second quarter end, but our projected third quarter end community count is down about 7% from a year earlier. We project a fiscal year-end 2018 community count of approximately 315 compared to 305 a year earlier.

Now let me turn it over to Bob.

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

Thanks, Marty. Jobs are plentiful, unemployment is low, wages are rising and existing home price appreciation is providing the equity for customers to buy new homes. Homeownership and household formation rates are increasing while supply remains very constrained.

With our solid land positions and the capital to expand, we are gaining market share and look forward to continued growth.

Now back to you, Doug.

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

Thank you, Bob. Thank you, Marty. Laura, we are ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question today will come from John Lovallo of Bank of America Merrill Lynch.

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

The first question is the third quarter gross margin -- adjusted gross margin target of 23.4%, yes, would imply, I think, down about 160 basis points year-over-year despite some benefit from those delayed California closings that you mentioned. What are the kind of big drivers of that outside of maybe labor?

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

I think the biggest driver is just a function of mix, John. But as we've mentioned, Q3 and Q4 of '18 are going to be improved over Q2 here. So things are going in the right direction.

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

Okay. Then maybe just on the labor comments that you guys made. It seems that you do utilize a slightly different labor base than most of the other public homebuilders, and your competition is more kind of the local guys. I mean, what is driving, in your review, kind of the increases in labor? Is it just a lack of availability of workers? Or what's going on there?

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

John, yes. First, I don't think we use a different trade base than the other builders, with the exception of maybe some finished trades that are a little more custom and capable of finishing our homes to the higher standard that we demand and our client demands. But we're all, as an industry, in this together. And as we've all talked about, labor is tight. It's a combination of, I'd say, probably 20% or 30% labor and the balance right now being materials, #1 of which of course, is -- lumber is up significantly, but it's really across the board with the labor force and then, as I mentioned, a couple of different, pretty significant materials, primarily lumber, that go into the home. But we're all in this together. I really don't think there's a difference for Toll Brothers versus the other builders.

Operator

The next question will come from Dan Oppenheim of UBS.

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

I just wanted to ask about that, terms of the California delays. You talked about the percentage of revenue getting to the 30s later in the year and just -- it seems that, that might mean that the -- some delays persist a little bit longer is -- trying to just get a little more color on that in terms of how you're thinking about backlog conversion for the third quarter and sort of the overall mix there.

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

Yes, Dan. I don't think the delays we're seeing are anything out of the ordinary. It's the typical -- there've been some construction delays due to some labor issues. We have some buyers that request the delay. Our houses are big and very complicated. And as you know, in California, our price point is higher, which means the houses are bigger and have more options. It's something we're managing. It's something we're very focused on. And I'm confident that the situation will improve, but it's nothing that causes me great alarm. We've all been doing this a long time, and we can bucket these delays into the normal categories, some of which I just mentioned. And we're going to do our best to manage it, but I would not be alarmed that this problem is going to increase or continue to the extent we just saw.

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

And just in order of magnitude, Dan, we're talking 15 homes, and they have that much of an impact on our margin because of the price point of those homes and the fact that their margin is 5% to 7% higher than our average.

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

Right. And I guess, but so -- for backlog conversion for the second half of the year, should we expect that to be similar to what it was in the second half of '17 or continue at sort of a lower level relative to '17 than it was in the second quarter?

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

I think in the guidance we've outlined, we've taken into consideration the volume of business in California and the situation we just encountered here in the second quarter. So I think you're looking at a backlog conversion of 30% for the next quarter.

Operator

The next question comes from Dennis McGill of Zelman & Associates.

Dennis Patrick McGill - *Zelman & Associates LLC - Director of Research and Principal*

First question on the gross margin comments, Marty. Can you maybe segment the 3 items you mentioned as far as order of magnitude, which was more impactful? And then related to that, with the discounting that you're doing in New York City to clear the inventory, the fact that you're holding guidance for the full year, does that mean you're making up for that someone else? Or that you're sliding just at the lower end of that versus what you might have thought before?

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

I think our success in California is offsetting our success in New York City, with respect to that strategy. So I think from that perspective, you could say we're making up for it. As it relates to the 3 components, they were second quarter issues and they were equally weighted around 10 to 15 points each, California delays, New York City success in inventory clearance, and cost creep from labor and materials.

Dennis Patrick McGill - *Zelman & Associates LLC - Director of Research and Principal*

Okay, great. And then second question, with the success that you're guiding to with respect to getting more communities open and the strong absorptions you're seeing today, would you anticipate that there's any trade-off between absorptions and community count as you go forward or either from mix or from how you're going to price the product?

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

No.

Operator

And next, we have a question from Paul Przybylski of Wells Fargo.

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

Actually, this is Stephen. Quick question, the gross margin broke below 20% this quarter, I know that's temporary. But long term, it's come down. So I guess a couple of different things, one short term and one long term. Your guidance for 4Q implies you're going to be meaningfully up and up year-over-year. Is that the inflection point when we're looking short term as far as year-over-year comparisons? And then, Doug, as you look at longer term, it's down from where you all have historically been. You've got a lot of product mix and geography mix that's changed. You're pushing your land to more options, et cetera. But I guess if you could just help us out, how you all think about the business today versus maybe you thought about it 10, 15, 20 years ago from a gross margin perspective.

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

Stephen, I guess I'm a little confused by your reference to an inflection point in the fourth quarter. That will obviously be the high point of our margin for this quarter -- I'm sorry, for this year, as it benefits from California becoming an increasingly large percentage of our total deliveries...

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

Yes, I was -- I'm sorry...

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

We have no (inaudible) on margins for '19 yet.

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

Yes, I'm sorry, I was talking about a year-over-year basis, Marty, where the first 3 quarters are down, and it looks like, as you go through the numbers potentially, including capitalized interest. It looks like maybe fourth quarter will be up. So just wondered if that was, if you sort of anniversaried all of the decline in the gross margin.

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

I think that's certainly the case for the fourth quarter, and we'll give '19 margin guidance at a later date.

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

Okay, fair enough.

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

And Stephen, with respect to your broader question about whether we look at the business differently today with respect to gross margin and ROE and other metrics compared to 10 or 15 years ago, the answer is no. We are very proud of our margins. They are among the highest in the industry. We have also, as you know, worked very hard in the last couple of years to improve ROE, and we've -- I'm very proud of the results that are paying off on the ROE. I think you'll continue to see that improve as we continue to do the things Marty mentioned, which is option more land, be more creative in land buying, move opportunities off balance sheet where appropriate, buy back stock, issue dividends. And we're very focused on enhancing shareholder value through improving the ROE, but we're most focused on driving earnings. And we will continue to work hard to buy the best land. We raise price when we can. California right now has significant pricing power, but we are also sensitive to making sure that we move through the land that we have and that, of course, is an ROE focus. So for us, it's a balance. It is no different from what we did in prior cycles. Obviously, in prior recoveries, there was more pricing power, so ROEs were naturally improving because those with land were rewarded, and this recovery has been a bit different where there has not been as much pricing power. And so we have focused more and more on the other levers that we must pull to improve the ROE, but you will continue to see us balance margin with ROE.

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

Got you, then. That's really helpful. And then on multifamily, you all have really started to -- or you've been accelerating that business, if you will. I guess, can you just give us a little more view about what's happening, what's going on there? To me, as we look at markets, we see a lot of inventory in the central business district with towers, et cetera, but we don't see much inventory at all as you start to move away from that and more mid-rise, low-rise, that type of thing. So just trying to understand how you all are looking at that business and what you expect going forward from it.

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

Stephen, we're very excited by our apartment business. As we stated today, we now have over 16,000 units in various stages of entitlement, development or lease up or stabilization. We have expanded the business beyond our core market of Washington, D.C. to Boston. We now have teams in major cities around the country. It is a blend of suburban garden apartment, infill mid-rise and city high-rise. And that applies not just to the East but in the newer markets that we've mentioned that we've entered. Our team is performing very well. We have a strategy of doing all this off balance sheet. It has a very high return on investment, return on equity. And we have a strategy. Generally, for every 3 we build and stabilize, we will sell 1 and hold 2. So we will return earnings to our shareholders regularly. And as that business grows, obviously, there's more 3, so there is more 1 that we sell, but we'll also be building a longer-term portfolio. And we think that's a good balance, and we're really excited about where that business is headed. And I think you're going to see terrific growth and strong earnings coming out of it.

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

Doug, could I ask you quickly on that. You're at 16,000 now. As you look out maybe over 3 years or something like that, what would all you be more comfortable taking this business?

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

It's in the early stages right now. It's only for us about 4 or 5 years old. So I would be very comfortable with this business doubling. I think there are plenty of opportunities in the markets we're now in, plus many more markets that we haven't even begun to enter or even begun to look at. This year alone, we have -- Gregg, how many properties that will be under construction this year?

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

(inaudible)

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

Hold on. We have 2,300-plus units that will be in construction this year. Average size is 300 to 350, so call that 8 or 9 new properties this year alone that are going up.

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

And remember, Stephen, this business has a tendency to recycle capital so that you can build the next building with money from the last building through the refinancing or sell-down process. So our capital investment in this is approximately $0.25 billion dollars right now, maybe $300 million. And that's with maybe a dozen projects we haven't found partners for yet. So that would go down when we get the partner's money to buy 75%. So we're really excited about the capital efficiency of this business.

Operator

And the next question comes from Susan Maklari of Credit Suisse.

Christopher Frank Kalata - *Crédit Suisse AG, Research Division - Research Analyst*

This is actually Chris on for Susan. It looks like you're expecting a pretty significant ramp up in community count in the back half of the year. Is there any risk that some of those communities get pushed back in 2019, given the labor constraints you're seeing out there? And could you just give us a better sense of like the location and overall profile of these communities?

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

Sure. I'll answer the second part first. The communities are really spread around the country. We've got a whole bunch, 16 of the 75 in Pennsylvania, but then we have -- and 5 in New Jersey. We have 10 in Nevada, 5 in Southern California, 8 in Boise, but again, those numbers I gave you probably adds up to 1/3 of the total. So it's really widespread in most of our markets nationwide. With respect to labor and whether there's a risk of the communities getting pushed out, there's always the risk of some communities being pushed out. It's not because of labor. We certainly have the land development crews to get, in most cases, get the roads in, get the community ready to be opened. It's more about the permitting. The permitting process in all almost of our markets is complicated. It's tedious. It takes time. There can be 20, 30 permits associated with a full land approval. And that final permit you need from the County Soil Conservation District, to give you the green light to go, which our team may believe is coming in June and it comes in July or August can lead to a community being pushed out. But we're good at it. We've hedged a bit in terms of the projections we've given, because we know historically that everyone we think may open will not. So I am comfortable with the guidance we've given. And I think we're in good shape.

Christopher Frank Kalata - *Crédit Suisse AG, Research Division - Research Analyst*

Got it. And then could you just talk more on the regional differences you're seeing in California? Are there any specific areas that are driving the strength there? How are you guys approaching the pace of land acquisition in that state?

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

So we are in, what I'll call, the best locations of Southern Cal, L.A. and the best locations of Northern Cal, San Francisco. Both markets and the submarkets around those 2 cities are performing very well. Down south, I'd say Orange County is the best submarket. And up north, we have more activity in the East Bay than the South Bay, but they are both very, very strong. With respect to land acquisition, we're active. We've seen some very interesting and exciting deals in the last quarter. It's very competitive. Land is obviously very expensive in California. We put a lot of diligence and thought into everything we do out there. But based on the deal flow that I am seeing, I think you'll continue to see strong results and good growth out West, out in California.

Operator

The next question comes from Michael Rehaut of JPMorgan.

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

First question, just -- don't mean to beat a dead horse, but I think it's the big focus on the results today. Understanding the gross margins a little bit. Marty, you highlighted labor and materials as being one of the drivers a little bit to the downside here. I think most other builders have also cited labor, materials as a continued source of inflation, but perhaps with an ability to, at minimum, offset those pressures through price. Just was curious, given the solid pace that you've had and there's always a balance of pace versus price, if you feel that at this point, you're able to fully offset it, obviously, you talked to most of your areas right now, continue to have very strong demand and you highlighted California not being impacted by rates or SALT. So just thoughts around your ability to offset labor materials going forward.

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

Well, Mike, I appreciate the focus of the question. And I think we've said that we expect margin improvement in every product line and in every region in the third and in the fourth quarter. The most impactful of those regions is California because of its already high gross margins, and it becoming a larger percent of total business. So every community stands on its own, and we are able to achieve price increases in some that offset the cost increases. In others, it's not able to be done. But overall, we're looking at improved margins for the third quarter and the fourth quarter.

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

There's (inaudible) impact there. The pricing of our units is not based on cost, neither should it be for any other builder. We try and get as much as we can. And we try and get that, not tied to cost but tied to demand that we feel in the market. So the offset feature of the increase in prices is really not there. When you see these prices going up, it's because we have greater demand.

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

Right. I understand. I appreciate that. I mean, just kind of following up on that in terms of pricing power. Do you have a sense of the percent or rough percent of communities that you're able to raise prices this past quarter and the rough amount and how that might compare to the prior quarter?

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

I do not have that, Mike.

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

Okay. Just one last one. Coming back to a question on apartment, the apartment business and the growth there. And Doug, you said that you could see that potentially doubling over the next few years. I was hoping to just get kind of a brief recap of how you see that business from a returns standpoint, relative to your core business. I mean, we -- you have another -- one of your large competitors that's ventured into the apartment business as well, and I think over time, is looking to -- looking at options along with some of its other ancillary businesses to refocus on the core homebuilding operation. It seems like you're looking to kind of build this -- further build this out over time. And could we see it getting to a bigger percentage of pretax income over the next 3 to 5 years?

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

Sure, Mike. With respect to returns from this business, the projects themselves are underwritten to upper teens, low 20s returns. And with our promote, we add maybe 5 percentage points in our expectations to what we hope to achieve. With respect to the size of the business and its contribution to income, last year, it contributed around $25 million to our pretax bottom line. And this year, we expect that to double. A lot of that is impacted by the pace and amount of gains on dispositions or sell-downs of our interest. And so at this point, we have not fully baked what we expect for 2019, but we are intending to grow this business such that the sales of buildings get a little bit more routine than they are right now.

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

And Mike, I will add that the multifamily team runs independently. It has its own land teams. It has its own construction teams. It has its own management and leasing teams. And I don't think at all are we distracted or not focused on the core business. We don't have land acquisition managers that are bouncing between multifamily opportunities and for sale. Occasionally, they may overlap because there may be a property that could be suitable for either, and then we in here get to make that decision. But I'm very proud and happy with how the Apartment Living group is running, and I'm very proud of how the homebuilding team is running. And I believe longer term, we can continue to build both businesses efficiently and effectively.

Operator

And our next question comes from Megan McGrath of MKM Partners.

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

I wanted to circle back to order growth in the quarter. Obviously, some mix results from a net perspective. But can you talk us through, were any regions down year-over-year on an absorption pace growth perspective? Or was it all -- the declines due to community count declines?

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

Megan, the only reason an area may be down would be because of community count being down. On a same-store basis, on the number of sales per community for the quarter, the divisions are up.

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

Great. And maybe a bit of a longer-term follow-up on California. Given that it's contributing so much to your revenue and gross margin growth, if I think about -- you talked about a little bit about the land acquisition pipeline. If you look at your landholdings there now and your community count plans, will it represent as much or more, in your view in the next, let's say, 12 to 18 months than it is now? Or are we seeing some kind of short-term peak in the California representation?

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

Hold on. Let's get the numbers for you. Gregg?

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

(inaudible)

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

Communities.

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

(inaudible).

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

So Gregg is putting in front of me the numbers on community count throughout the year. We started fiscal '17 with 38 selling communities in...

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

Fiscal '18.

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

Excuse me, fiscal '18, I have year-end '17...

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

Okay, so you're half right.

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

One day later. So we ended fiscal '17 with 38 selling communities in California, and we project to end fiscal '18 with 39 plus 1.

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

Okay. And looking further out, I mean, I guess my question really is that, kind of like how -- is this like -- are you comfortable with this level of contribution from California? Would you like it to get bigger? Is there a point at which you would be uncomfortable that would be contributing so much to your revenue base?

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

So with respect to '19, we're not going to give specifics on community count or community location except for my general comment when we started the call that right now, we have owned and controlled land in place to grow community count in '19. And that, of course, is before we continue to see deal flow and we have the deals in the pipeline that should add to that.

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

We have 5 different markets in California: Northern Cal in San Francisco and Sacramento, Southern Cal, San Diego and Los Angeles and a little bit in Palm Springs.

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

Yes. And Palm Springs and Sacramento are very, very small. Our business is driven by San Francisco, L.A. and the northern side of San Diego. I'm comfortable with our size right now in California. And based on the deal flow that I see, the land that we're working on, I'm hopeful that we can sustain it at this level.

Operator

And the next question comes from Nishu Sood of Deutsche Bank.

Timothy Ian Daley - *Deutsche Bank AG, Research Division - Research Associate*

This is actually Tim Daley on for Nishu. So the first question is on the lowered outlook for community count growth this year. It doesn't seem like early close outs were the driver. Volumes came in line with your expectations, and it doesn't really seem like it was community delays, as kind of the gross number of openings planned in the second half of the year actually went up. So if you could just help us reconcile the moving pieces behind the revision, that would be super helpful.

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

Sure. A small part of it is sellout. We've had excellent sales. And so a few more communities have sold out faster than we anticipated. So that is certainly part of it. And the 75 communities that will be opening in the second half, some of that is because we thought they may open in Q2 and now they're being pushed to Q3. So it is a bit back-end loaded, not so much because we ran out and found new land, but because the timing of the entitlements, as I mentioned earlier, is not always perfectly predictable. And if we lose a month or 2 or 3, we can have a community get pushed out. So that's really what is driving it.

Timothy Ian Daley - *Deutsche Bank AG, Research Division - Research Associate*

Appreciate the color there. So I guess second question then, is we're thinking kind of the changes in the community count trajectory and as well it seems like there might have been some -- a bit more intensity put on the closeouts of the standing inventory and the condo projects in New York. So if we're just thinking about kind of the operating cash flow expectations for the year, what kind of level are you guys anticipating? Obviously, '17 was very impressive. So just if you could help us, I guess, understand that.

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

Sure. So -- and this is -- these are figures after land purchases and improvements and not reflecting any debt raises in excess of debt paydowns. So we think it's somewhere between $250 million to $350 million.

Operator

And next we have a question from Stephen Kim of Evercore ISI.

James A. Morrish - *Evercore ISI, Research Division - Analyst*

It's actually Trey on for Steve. The first question is -- touch on the New York City apartment. How much generally did you cut your margin expectations for those units that you're trying to push through? And do you expect to be through those by the end of this year? Or do you think they could linger a bit into '19?

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

So I think there is a potential for some of them to linger into next year because the -- our appetite for margin reduction is not unlimited. So we set expectations at the beginning of the year for margins in the mid to upper 20s. This quarter came in a bit below that, but we're still comfortable with that amount for the full year.

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

And I will mention that we have a number of buildings that are under construction and actively selling where we don't -- this is not the inventory issue we've been talking about, that are doing very well. At $2,000 a foot in New York City, in the locations where we build, the market is healthy.

We're seeing very strong sales. We're also seeing very strong sales in Jersey City. We talked about the building over Provost Square now for the last year, and that building will begin delivering in the fourth quarter. So the focus that we talked about on this call has been with the lingering remaining units in buildings that are completed and occupied, some of those units are small and there's a few of those units that are large and very expensive. And it's the larger, more expensive units that we have had to discount more because the upper end of the New York market is where there has been more issues. And we -- for example, we moved one very expensive unit out in the second quarter, and that unit required discounting to be sold. And thankfully, we only have a couple of remaining large units in New York that we're hoping to work through over the next 6 months.

James A. Morrish - *Evercore ISI, Research Division - Analyst*

Okay. That's helpful. And then second, turning back a bit to labor, which you cited as an issue. But you guys also have the Toll integrated systems to help kind of offset some of those labor challenges. And I'm wondering if you could talk a bit about what you're doing at TIS to maximize the axis of labor that you do have.

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

Yes. So TIS is our panel and truss operation. We have 4 panel and truss plants that serve the Northeast, Mid-Atlantic and Midwest. And it solves a lot of labor because when wall panels and roof trusses are built in our factories, you have framers on site for a week instead of 2.5 weeks because the -- obviously, panels and trusses arrive and they just get erected. And our labor force in those plants is solid, it's secure, it's been with us for many years. And that has certainly helped us in those markets I mentioned because we have the plants.

Operator

Our next question will come from Jack Micenko of SIG.

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

Last couple of years, it looks like G&A has levered couple hundred basis points between the 2Q into the 4Q. And this year, the guidance is a lot less, obviously opening a lot of communities. Is that part conservatism? Is it all the community openings? Just trying to understand that. And then the apartment personnel and teams you've added, I believe that flows to the JV lines, that's not a driver of -- I'm trying to figure out if the company is reaching terminal velocity on your G&A leverage or if there's more to go beyond the community openings in the back half.

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

So on the G&A leverage, I think we reiterated our guidance. That is a 50 basis point improvement from the year prior, and we think there's room in the future as well, but we're not going to get into that at this point, Jack.

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

Okay. And then, Marty, on the buyback. I guess you like it at [45], you love it at [40]. How soft is that soft target of $400 million? And I guess at a higher level question, is growth or ROEs a bigger focus?

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

So it's tough to answer that equation without a focus on what's in the land pipeline, what's in the debt maturity pipeline and what's in the M&A pipeline and what's in all the opportunities pipeline. So I think we gave you a soft target in our commentary. And ironically, the dollar price of the stock is not all that meaningful to the return on equity. It helps the earnings per share a little bit, but $100 million out of equity is $100 million out of equity, whether you divide it by $45 or $40.

Operator

And our next question comes from Jade Rahmani of KBW.

Ryan John Tomasello - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Good morning, this is actually Ryan Tomasello on for Jade. Just firstly, in terms of demand, are you seeing any noticeable impact in your buyer segments from either the rising rates or declining affordability from the strong HP we've seen?

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

House price.

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

Yes. In my prepared remarks when we started, I talked about rates. We don't -- they have not impacted our business. Look at the second quarter results. Our sales teams around the country have had nothing to say, have had no issues. So on the rate side, a 4.87% rate as I mentioned, is still a low rate and is only 75 basis points up from a year ago. So right now, we're very comfortable with our business and no issues out there. Home price appreciation, it is also not been a factor, except we saw move-up homes generally, which means people looking to move up have more value in their existing home, more equity and appear to be more interested to move up to our houses.

Ryan John Tomasello - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

Okay. And then just in terms of the impairments in the quarter, can you give us some more detail on what drove that? And then did any of that relate to the New York City condos you spoke about?

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

It did not. Go ahead, Marty.

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

There was 1 community in Connecticut in particular that drove the majority of that impairment, it's approximately $12 million. It was a bit of a returns-focused change in strategy. We had slowly been working through this for a number of years. But now we acknowledge that the right course of action is to accelerate sales and recoup our investment as soon as possible so the proceeds can go elsewhere.

Operator

And next, we have a question from James McCanless of Wedbush Securities.

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

The first question I had on the entitlement, I mean, it sounds like that's your biggest headwind when it comes to the reduction in the community growth guidance. Do you foresee this getting better as we move through the rest of the year? Or is it still the municipalities just don't have enough people to get the permitting done timely?

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

Jay, it hasn't changed much, so I don't think it's going to get worse, and I don't think it's going to necessarily get better. We build in a lot of tough places. The corner of Main and Main, and the best towns in our markets are generally difficult places to build, and there's a lot of permitting. And we're good at it, and we're in the middle of it. It takes time. Most of the time, we hit it right on. But occasionally, we have a little bit of slippage. It's not about how busy a municipality or a county or state is. It's just the complication of the permits. And so we fight the fight every day. As I said, we have hedged our number a bit to you for this year because we have historic data and we know that every community that our teams tell us will open will not, but most will. And going forward, based on the deal flow we have, the land we have secured, I'm very confident that we will continue to have community count growth.

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

And then the second question. Looking at the slowdown in the West from almost 40% order growth in the first quarter, It's -6% this quarter, and then the continued soft results in the Mid-Atlantic and the North segments, was there any weather impact this quarter? Or was it all community-driven?

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

It was community count decline in the West. It was not weather-related.

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

And in the North and Mid-Atlantic, it's similar.

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

That's correct. Right.

Operator

The next question will come from Matthew Bouley of Barclays.

Matthew Adrien Bouley - *Barclays Bank PLC, Research Division - VP*

I just wanted to follow-up on the California gross margins and kind of the longer-term trajectory there. You're calling for the sequential improvement this year. I think in the past, you had called out an expectation for a year-on-year decline in California for the full year of 2018. So the question is, just kind of how are you thinking about the sustainability of those California gross margins, that premium versus the rest of the business beyond the next quarter or 2?

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

So margins in California prior to this year were benefited by a rapidly appreciating environment and some land purchases that are very early time in the cycle. We are at the low point right now of our margin in California compared to Q3 and Q4, and we've been encouraged by what we see out there as it relates to 2018 fiscal year end and the pricing power we have looking forward.

Matthew Adrien Bouley - *Barclays Bank PLC, Research Division - VP*

Okay, understood. And then also following up on the City Living gross margin side, kind of beyond the efforts you're making here on clearing inventory in New York and also really thinking beyond the next 2 quarters. So if you could kind of comment on where you think at this point what a more normalized gross margin will look like in the City Living business.

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

We underwrite those buildings to a mid-30s gross margin, maybe a little higher over in Manhattan, a little lower on the Jersey side, and we have a building delivering in the fourth quarter and through the first 3 quarters of '19 that is hitting those in the Jersey City side, and that will be pretty much the dominant piece of volume coming out of New York on balance sheet for this year -- next year, next year.

Operator

The next question will come from Ken Zener of KeyBanc.

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

Given where community counts are and obviously the back half ramp. I'm wondering if you could talk to the impact on SG&A, specifically kind of, I guess, the fixed component of that. How that might look, obviously with higher closings, better fixed cost absorption, but could you talk about cadence a little bit?

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

Sure. So the gross margin guidance for Q3 is better than Q2 despite an increase in community count.

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

For SG&A specifically.

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

I'm sorry?

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

For SG&A, not the gross margin.

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

Excuse me. For SG&A, again, we expect revenue volume to create efficiencies despite a little more G&A associated with community count openings. So it should trend down in the third quarter, even more in the fourth quarter. We would expect to continue to leverage G&A in future years below the 10% guidance that we set for this year.

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

Okay, good. And then I hear -- I'm not asking about gross margin guidance. I think you've been -- you explored that enough. I'm interested more, just, the kind of the process. Because you guys have larger, longer (inaudible) homes, longer build times, how might you be controlling these costs for lumber, for example, I know some builders reprice those bids with the trade and distributors every 30 days. Is there a way to kind of think about how you, with your longer build time, might address those front end cost changes differently than other builders?

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

Traditionally, with a bit of our volume going through from a lumber perspective in particular, the TIS plant, we've been able to buy in bulk and get some benefit from that and also buy in advance and get some benefit.

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

Right. So the Northeast, Mid-Atlantic and Midwest are benefited by the plants. All of our plants are on rail lines. We're able to bring in rail cars of lumber so we can buy out maybe 2, 3, 4 months, because we have a lumber yard warehousing operation where we're able to do that. In the other markets, I think we have, even though our homes make take a little bit longer to build, most of the added length is on the finish side, which is beyond lumber hitting the home. And I don't think we have a different situation than the other builders. We do our best to manage the lumber buying, either by ourselves or by our framers, to buy out in advance as much as we possibly can. And if we can get out a month or 2, that would certainly be our goal. And that's what we strive for.

Operator

And our last question today will come from Alex Barrón of Housing Research Center.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

I wanted to ask, given the rising rate environment, whether you guys are thinking or actually shifting your price points or your size of homes or anything to make homes more affordable? That's my question #1. And my other question is, if you can give us an update on how Vegas is doing for you?

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

Alex, with respect to the mix, we, as we've talked about, have I think the greatest variety and diversity of the mix in the industry. So we're building the $2 million plus houses in places like California and the $300,000 homes in Boise and the $400,000 homes in Jacksonville, et cetera. So we have been shifting a bit to fill in the lower price point. And that has been naturally happening over the last couple of years. That is not driven by mortgage rates. In fact, remember that our clients have much higher credit ratings, they put more money down. And it's generally easier for them to get a mortgage because they're not tapped out when rates go up a little bit. So the strategy for us, to be more diversified is, I think, just a smart strategy based upon the growth of this company, the geographic diversity of the company and the demographic trends of more millennials buying homes, but is not being driven by the rate environment.

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

And we're seeing 25% of our buyers this quarter pay all cash, and that compares to a historical average of around 20%, which has trended up pretty steadily over the last 3 quarters. And we only see approximately 15% to 16% of our buyers taking adjustable rate mortgage. If affordability was an issue, that would go up instead of it having gone down around 5% in this most recent quarter.

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

And those that get a mortgage, the average LTV is 70%, so they're not maxing out their mortgage.

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

We have a very large component of our business in active-adult housing. What is the is average mortgage?

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

About half of those buyers pay cash, and they are about 20% of our total. Second question concerned about how the Vegas market is doing. The market feels pretty good. Our community count has declined in the most recent quarter.

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

Yes. We started the year with 11 communities in Las Vegas. Right now, we're at 9. And at year-end, we project to be at 10. But in terms of same store, business in Vegas is still very good.

Operator

And this concludes our question-and-answer session. I would like to turn the conference back over to Douglas Yearley for any closing remarks.

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

Thank you, Laura. Thanks, everyone, for listening in, and have a wonderful Memorial Day weekend and summer. Thank you.

Operator

The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.