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Toll Brothers, Inc. (TOL)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. And welcome to the Toll Brothers Fourth Quarter Fiscal Year End Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] Please note this event is being recorded.

I would now like to turn the conference over to Douglas Yearley, Chairman and Chief Executive Officer. Please go ahead.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Gary. Welcome. And thank you for joining us. I hope you, your families and colleagues are staying well. With me today are Marty Connor, Chief Financial Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Wendy Marlett, Chief Marketing Officer; and Gregg Ziegler, Senior VP and Treasurer.

Before I start, I ask you to read the statement on forward-looking information on our earnings 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, the impact of the COVID-19 pandemic, and many other factors beyond our control that could significantly affect future results.

Now, let's begin. I will focus primarily on the current sales environment, and then turn it over to Marty and Greg to address our financial results and our guidance. In these challenging times, our team delivered on all fronts and our fourth quarter, exceeding our expectations for sales, revenues, margins and earnings. I am tremendously proud of how we have adapted to a rapidly changing environment.

We are currently experiencing the strongest housing market I've seen in my 30 years at Toll Brothers, and we continue to increase prices in nearly all of our communities, as we focus on driving profitability and managing growth. The strong demand began for us in mid-May and has continued through today.

In our fourth quarter, which ended October 31st, net signed contracts of 3,407 homes and $2.74 billion were the highest totals for any quarter in our history, up 68% in homes and 63% in dollars compared to one year ago. In the first six weeks of our quarter through December 6th, our non-binding reservation deposits, which are a precursor to contracts, are up approximately 48% compared to one year ago.

Demand has continued to be very strong in the first quarter. In fact, this Saturday, we will raise prices nationwide for the fifth time this calendar year. Layered on top of these national increases are many more frequent community-specific price increases.

As we previously announced, midway through our fourth quarter, net signed contracts were up 110%. We strategically moderated the sales pace in the second half of the quarter by increasing prices in nearly all of our communities and limiting lot releases in about 15% to 20% of our communities.

What this means is that, for these communities, we put in place a monthly allocation of homes to sell. We employ this strategy in some of our hottest selling communities, where there is a limited finished lot supply, or extended delivery times due to prior strong sales. Of course, in these communities, we have some of the best pricing power around the country. We've continued this strategy into our first quarter of fiscal 2021.

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Our 10.8 contracts per community were our highest fourth quarter ever and the highest for any quarter in 15 years. Our cancellation rate for the fourth quarter, fourth quarter cancellations divided by fourth quarter contracts, dropped to 5.4% from 8.9% in last year's fourth quarter. Our buyers typically provide a non-refundable down payment of between 7% and 10% of the purchase price, which results in the lowest cancellation rate among the major builders.

In fiscal year 2020's fourth quarter, our traffic to deposit ratio of 9.9% and our traffic to agreement ratio of 6.7% were our second highest conversion ratios ever. Customers who visited our communities, whether in person or online or intent on buying.

We see strength in every region. Even our city living urban high-rise division, which is focused on Metro New York City, is showing some signs of improvement. We attribute the strength in demand to a number of factors, some of which apply to the homebuilding industry in general and some of which are specific to Toll Brothers and our customers. We believe the market is on a solid foundation and has significant room to run. Historically, low interest rates are driving the new home market at all price points. We expect low rates to continue for some time.

Additionally, a very tight resale market is leading more people to the new home market. Currently, there is only 2.5 month supply of resale homes on the market, the lowest on record. Resale homes are moving quickly. According to Redfin, in October, a record high 35% of all re-sales nationwide sold above asking price.

Also, there remains significant pent-up demand due in part to the under production of new homes over the past decade, as well as the impact of many millennials delaying homeownership decisions. We are finally seeing the millennial generation start to transition from renters to homeowners.

Based on the annual average rate of new home production over the past 50 years and the growth in US households, we estimate the industry has under produced nearly 6 million single-family homes since the start of the housing recovery in 2008. That 6 million fewer people that bought a home in the last decade, who would have in prior decades. Even now, production is just reaching historic norms.

In addition to these positive industry trends, there are tailwinds supporting Toll Brothers upscale market segment and build-to-order strategy. Since most of our customers have a home to sell, the tight resale market gives them confidence they can sell their home quickly and at an appreciated value that can then be reinvested in their new home. The job picture for our customer base is solid and improving.

The work-from-home phenomenon is driving demand, as it allows more buyers to live where they want, rather than where their job previously required. Due to this phenomenon, we are seeing an increase in relocation traffic. We also believe our more affluent customer will have greater flexibility to work remotely and is therefore, out in the market looking for their ideal home.

Our build-to-order model is particularly well-suited to this moment, as Americans place more importance on their homes. Our expansive, flexible floor plans provide buyers with more space for living, learning, working and entertaining. Whether it's home offices, fitness rooms, multigenerational living suites or stunning indoor, outdoor living areas, we offer the features that customers desire as they personalize their homes to reflect their lifestyles.

This quarter, our buyers added, on average 22% of the delivered price or $183,000 in upgrades to their homes. So, as we look to fiscal year 2021, we believe we are well positioned for growth. With our highest year-end backlog in 15 years and continued strong demand, we expect to deliver the most homes in our history in fiscal

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year 2021. In addition, our longer land position is helping fuel growth. We ended fiscal year 2020 with 317 selling communities, and we expect to grow this by approximately 10% by the end of fiscal year 2021.

We also expect our gross margin to improve over the course of the year, as the price increases and strong sales since May are reflected in homes we deliver in the last three quarters of the fiscal year and we are very focused on improving ROE. Gregg will speak more to this in a moment. In short, we are very pleased with our performance in 2020 and look forward to continued growth in fiscal 2021.

Now let me turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. In fiscal year 2020's fourth quarter, we delivered 2940 homes and generated revenues of $2.5 billion, which were up 10% in homes and 8.9% in dollars from one year ago. The average price of homes delivered was $849,000.

Delivery total exceeded our guidance, thanks in large part to great execution by our team. In addition, our backlog cancellation rate was lower than anticipated. We delivered many more spec homes than projected, and buyers were more eager than ever to close as soon as possible and move into their new homes.

Fourth quarter net income was $199.3 million or $1.55 per share diluted compared to $202.3 million and $1.41 per share diluted one year ago. Our fourth quarter adjusted gross margin was 24% compared to 23.9% in both the fiscal 2020 third quarter and one year ago.

Please note that both current and prior period gross margins and SG&A expense are higher due to a reclassification in sales commissions paid to third-party brokers, which were previously included in homebuilding cost of sales and are now in SG&A. All historical periods and future projections presented reflect this reclassification.

This new treatment is consistent with the way we treat sales commissions paid to our internal sales force and conforms our presentation to that of the majority of our homebuilder peers. We have filed an 8-K with the SEC to detail the amount of the reclassification, but at a high level, it was approximately 2 percentage points of revenue in each of the last eight quarters.

SG&A, as a percentage of revenues, was 9.9% in the quarter compared to 11.1% in the same quarter one year ago. Again, both of these amounts reflect the third-party broker fee reclassification, I just discussed, and are therefore about 2 percentage points higher than they otherwise would have been. The year-over-year reduction in SG&A is due to our efforts to streamline operations and become more efficient in ways we believe will result in permanent cost savings. We continue to focus on additional steps to further reduce SG&A.

Joint venture, land sales and other income was $11.2 million during the fourth quarter, compared to $48.4 million in the fourth quarter of fiscal year 2019. Impairments and write-offs totaled $33.9 million in the quarter. $6.8 million of these impairments were from pre-development cost on proposed projects we control through options that we chose not to purchase, and $18 million was associated with our strategic decision to exit two markets.

Looking forward, we are projecting first quarter fiscal year 2021 deliveries of approximately 1,675 homes, with an average price of between $780,000 and $800,000. First quarter 2021 delivery guidance reflects our team's delivery of about 450 more homes than projected in our fourth quarter of fiscal year 2020.

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In addition, with our build-to-order models, buyers contract for their customized homes that we deliver those homes nine to 12 months later, therefore deliveries in Q1 2021 will reflect the slow sales environment we experienced in March through mid-May of 2020. We expect adjusted home sales gross margin in fiscal year 2021's first quarter with deliveries from this slow sales period to be approximately 22.4%. This first quarter adjusted gross margin is expected to be the low point of the year.

We expect interest in cost of sales to be approximately 2.5%. We expect price increases from contracts signed in our third and fourth quarters of fiscal year 2020, positively impact margins over the course of fiscal year 2021, and we expect adjusted home sales gross margin in fiscal year 2021 to grow steadily after the first quarter and be approximately 24.1% for the full fiscal year. We expect interest in cost of sales for the full year to be approximately 2.5%.

We project first quarter SG&A, as a percentage of home sales revenues, to be approximately 15.8% versus 16.8% one year ago. Included in first quarter SG&A is about $11 million or 80 basis points of accelerated stock compensation expense that is not expected to recur in the remainder of the year. Again, all of these amounts reflect the reclassification of third-party broker fees from cost of sales to SG&A.

First quarter other income, income from unconsolidated entities and land sales gross profit is expected to be approximately $25 million. We project the first quarter tax rate of approximately 26%. Our first quarter weighted average share count is expected to be approximately 129.5 million shares.

For the full fiscal year 2021, we are projecting new home deliveries of between 9,600 and 10,200 homes, with an average price of between $790,000 and $810,000. We expect approximately 60% of our deliveries to occur in our second half of the year and we expect average delivered price to dip in the second and third quarters due to mix. We project fiscal year 2021 SG&A, as a percentage of home sales revenues, to be approximately 12.2%.

We believe there is significant unrealized profit embedded in our stabilized apartment projects. We are choosing the first sales of these assets until markets improve. As a result, fiscal year 2021 other income, income from unconsolidated entities, and land sales gross profit is expected to be approximately $65 million versus $51 million in fiscal year 2020, with this concentrated in the first and fourth quarters to project full year fiscal 2021 tax rate of approximately 26%. Our weighted average share count for the full year is expected to be approximately 129.5 million shares.

Now, let me turn it over to Gregg.

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

Thanks, Marty. ROE is improving and should continue to improve over time. We expect to improve our return on beginning equity in fiscal 2021 by approximately 350 basis points compared to fiscal 2020.

As we seek to drive improvement in our financial metrics, we continue to apply more rigorous underwriting thresholds to new land deals to achieve both the higher gross margin and the higher ROE. We are focused on controlling more land through options, land bank arrangements, joint ventures and other strategies. We grew our owned and controlled lots to approximately 63,200 lots at fiscal year-end 2020 compared to approximately 59,200 at fiscal year-end 2019.

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We spent $603 million in fiscal 2020 on land acquisitions compared to $1.1 billion in fiscal 2019. So in other words, with our more capital efficient land buying strategy, we were able to acquire control of essentially the same number of high-quality lots in fiscal 2020 as we did in fiscal 2019 for about half the cash outlay.

We executed land banking transactions in fiscal 2020 that deferred approximately $190 million land spend. We improved our options to owned land ratio at fourth quarter-end to 43% optioned compared to 38% optioned at fiscal year-end 2019.

We ended our fourth quarter with a very strong balance sheet. We had $3.16 billion of liquidity, including $1.37 billion of cash and $1.79 billion available under our $1.9 billion revolving bank credit facility, which we recently extended out until November of 2025. We have no significant debt maturities until fiscal year 2022.

At fourth quarter-end, our net debt to capital ratio was 33.3% compared to 32.9% one year ago. This relatively flat net debt-to-capital ratio was achieved even while we repurchased approximately $634 million of stock in fiscal 2020. We generated approximately $1 billion in cash flow from operations in fiscal 2020. This was a record. With our strong balance sheet and focus on capital efficiency, we believe we are well positioned to continue growing our business, while also improving ROE.

Now, let me turn it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Gregg. Before I open it up to questions, I want to thank the entire Toll Brothers team and our trade partners for the results we produced together this quarter and in fiscal 2020. This was a year like no other, to require that we think and operate in new ways. We had to adjust to dramatically changing conditions while maintaining an unwavering focus on providing our customers with a superb quality, value and service they expect and demand from Toll Brothers.

To all of you, you went the extra mile, worked harder than ever before and truly extended yourselves to prove once again by our company as so special. I'd say, thank you. And especially to those of you on the front lines who are responsible for selling and building our homes and communities, you're resilience and commitment are inspiring.

As we look forward to fiscal year 2021 with our record fourth quarter backlog, continued strong demand, community count growth, improving gross margins and our focus on improving ROE, we are well positioned for growth in fiscal year 2021 and beyond.

Now, Gary, let's open it up for questions.

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QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question is from Stephen Kim with Evercore ISI. Please go ahead.

Stephen Kim
Analyst, Evercore Group LLC

Yeah, thanks very much guys. Exciting times. Doug, I was wondering if you could talk about the difference between Toll's gross margin structure generally today versus let's say 15 years to 20 years ago, totally ignoring this reclassification issue? It seems to me that there is generally what three main drivers, right? Prevailing home prices, construction efficiency and the value-add from land acquisition.

Let's take home prices and put them to the side, because everybody can make their own assumptions as what that's going to do. And so, I really want to look at the construction efficiency in land acquisition. I would assume you're building your homes more efficiently than you did in the past, particularly relative to the private guys you compete against, but on the land acquisition side, I imagine you probably have a little bit more – little less value add because of the move to affordable luxury and quicker turn land and all that.

So can you help me understand how big of a drag is this move to quicker turning land net of your better efficiency. I mean it would it be reasonable to think that the net of those two factors is like a drag and maybe a couple of hundred basis points relative to 10, 15 years ago?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. I'll do my best, Stephen. It's a big question. It's taken me back in time, which I enjoy doing. It's hard to keep price out of it. I know you asked we keep out of it because as you know, back in the early 2000s there was tremendous pricing power and we were obviously able to drive margins very, very high. But on your two points which are construction efficiency and land – yes, we are better builders today than we were 15 years ago.

This company has matured. There is no question that we bring efficiencies and I think you're going to see more of them as we are optimizing and rationalizing our home designs to make them much more efficient. We're trying to curate the upgrades that our clients can have, so less is more. It's less the contract, it allows us to buy trades better when they have 10 or 15 structural changes to a home as opposed to 30 or 40.

So we're spending a lot of time on home design and a rationalization process that is pretty deep into it right now. We're starting to see the results of that. On the land acquisition side, we are certainly not tying up as many farms in the suburbs of Philadelphia or the suburbs of Washington, D.C. or you pick the market and going through a three, four or five-year approval process and coming out on the back end after the market has appreciated over that time with land that is significantly under market. We still do that.

That's part of our mix, but as we have grown geographically into the many markets that have land developers that feed lots to us and where maybe the entitlement process isn't as tedious, so that you don't have quite the level of gold when you come out of the back end as you have in the places that we started this company and we're bigger like the Northeast, Mid-Atlantic, I'm sure that has had a bit of a negative effect on the margin because we don't have as much land development profit that is what went through.

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With respect to affordable luxury, quite the contrary. The gross margin coming out of affordable luxury the last few quarters is right there with our luxury business. That market has done well, we're extremely efficient on the construction side for the reasons I gave with rationalizing plans on the affordable luxury, we actually offered less upgrades.

I think we're buying trades even better. That market has been strong. We've seen significant pricing power and while we underwrote some of that to a little bit lower gross margin as we've discussed because it was driving a higher ROE, because in a lot of cases the affordable luxury land could be purchased just in time. Quite the contrary, the gross margin has outperformed our underwriting and is right there with our luxury business.

Stephen Kim
Analyst, Evercore Group LLC

Q

Yeah, that's really encouraging. So it doesn't seem like the headwind or the offset on land is all that great. Great. So given that, I'd like to delve a little bit into your comment about the strongest housing market in 30 years. You and I both go back a ways and certainly now, I would seem to encompass the period of what we all think of it as the housing bubble when times were very good.

I was just – you invoked Redfin and I was just looking at their data, which was up 17% in the most recent week – home price was up 17% and in the last three months, that absolutely matches the apex, the highest level of price depreciation that we saw in the housing bubble. So when you say that it's strong – the environment today is stronger than it was I would assume back then, can you give some commentary that would give us some contacts to perspective, things that you're seeing in the marketplace that would lead you to say that even relative to that period of time, things are stronger now?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. Well, Toll Brothers is very different today than we were back then. We have many more markets to look at. We have places like Boise, Idaho and Jacksonville, Florida, and we're now in Atlanta, doing incredibly well. I'm not going to waste your time going around the country, you know our business. So, I have a much wider lens than I had in 2005 and what I see nationwide feels stronger and it feels better. And let's focus on the better part, because by no means was my comment following the path.

I think we have a long runway, it does not resembles the market 15 years ago. Mortgage money is tight. What blew up 2005, 2006 was very, very loose underwriting. And I've told the story of meeting a blackjack dealer in Vegas who owned three houses in 2006 and that just can't happen today. We don't see investors in the market and we obviously had lots of investors back then. There is very low supply of used and new homes. There's huge pent-up demand as I mentioned was 6 million less people buying a home in the last 12 years, that it appears one who bought in the prior decades going back 50 years and we have this millennial generation that is now becoming homeowners, that is driving a lot of this activity and low interest rates that we think will be around for a long time. So when I say it's the best market I've seen, it's because I feel so good about this sustained strength. I'm not talking about one moment in time.

If you want to compare last week with Redfin's data with some week in 2005, I'm sure they are comparable, Stephen, but I'm talking about what I'm feeling over the last six months and for all of these reasons what I think is the sustainability of this market for a longer period of time. I do not expect 110% order growth. I do not expect raising prices in every other week, but I think we're entering a period with sustained significant order growth, and solid pricing power that has long runway power.

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Stephen Kim
Analyst, Evercore Group LLC
Q

Great, yeah. I agree. Thanks very much, Doug. Appreciate it.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Thank you.

Operator: Your next question is from Truman Patterson with Wells Fargo. Please go ahead.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Hi, good morning, guys. Been getting a little bit of a feedback on the call. So first, Doug, I wanted to touch on orders decelerated from up 110% in the first half of the quarter down to 40% and you said you intentionally capped that growth rate. Your pricing limited lot release, et cetera. I'm hoping you can help us triangulate a little bit, one, what was pricing? What did you push pricing from the beginning of the quarter, during the end of the quarter?

And you said you limited lot releases in about 15% to 20% of communities. What I'm trying to understand is how much did your intentional actions did create that deceleration versus we're starting to see a little bit of on local demand or not even a bit of an organic decelerating. Can you help us triangulate into that?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Sure. The move from 110% that we mentioned mid-quarter to the balance of the year was primarily strategic and self-induced by us. We raised prices more significantly as the quarter progressed and I talked about in 15% to 20% of our communities. We limited both the lots that are available. And the typical way it works is, we'll give a community, let's say, three lots a month to sell.

And when the month begins we raise the price and when the month begins, they already have people they're working with, because we certainly don't close the sales office for any means. We will sell those three in the first weekend and then they are shut back down until the next month and then we do it again at a higher price. And that has helped moderate sales only in that 15% to 20% of the communities, which tend to be our hot communities and they may have the biggest backlogs where the next homes sold is going to be a very extended delivery and they may also have less finished lots available, we have to get land development caught up to get more asphalt on the ground. So it's a lot of different reasons why it happens, but that's the basic premise behind it.

What I am encouraged by is that I look at these six weeks of December, but we will continue the same strategy and we mentioned 48% up in deposits. The last couple of weeks are stronger than the prior couple of weeks. So overall, can I tell you it's 100% self-induced? Of course not. We headed into Thanksgiving and now we're into December. There has been some sticker shock out there from some clients as we've been raising prices is no question, but I think it is primarily self-induced.

On your question about incentives, were up...

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Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

On price increases.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

I'm sorry, my apologies. The reverse of incentives, with less incentives, but the price increases, 20...

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

Yeah, Truman, we've been fortunate so far this year, we've been able to raise prices, in the Calendar year, or one-step price increases. Doug already announced another one and so in this most recent quarter you asked about, yes, we are showing good strength. We look across – if we tried to sell approximately the same house with the same house, we are showing somewhere in that ballpark. We said $20,000, not the perfect sign, because again, we're looking for, let's say, the exact house to sell, but if you're looking for a rough ballpark, hopefully that'll give you enough context on how strong the market is.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Okay.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

And – no, go ahead.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

No, go ahead, Doug.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

I was just going to say that it's important to understand that in addition to these nationwide price increases, we are also in most cases, in most of the price increases you see, your community specific based on local demand, that is the driver of most of the increases, but we are in the market where we have felt comfortable and confident that nationwide we can take the Company up and we'll have our fifth one this Saturday.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Okay. Okay, so $20,000 on generally and $800,000 ASPs. So kind of 2% to 3%.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

No, that was for the...

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Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

For the quarter.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

That's for the quarter.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Right, right, right. That's helpful. And your absorptions are up massively. I think over 70%, right. And you're still reiterating that 350 community count target are up 10% ending 2021. But you're also discussing limiting your lot releases as we think about your finished lot constraints, maybe even material and labor, but also assuming the demand remains extremely robust through 2021, what do you think would be the theoretical upper limit tier order growth, assuming that you could kind of fill everybody that comes in?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

We have capacity. Right now, we're selling in the low-30 sales per community, go back to Stephen Kim's time, 15 years ago, we were in the mid to high-30s. We're more efficient. I talked about our plans becoming optimized and easier to build. We've come down in price with affordable luxury. We've expanded to geographies that have more trade base. So there is absolutely capacity based on the sales environment that is put in front of us.

We opened 110 new communities in 2020. Obviously, there was more sell-outs than we expected due to the market. We are projecting to open between 150 and 160 new communities in 2021. So I'm not worried about improved lots, I'm not worried about capacity in the field in most divisions. I think our ability to continue to manage and balance price increases with controlled or manageable growth is our focus right now. And I'm proud of how we're doing with it.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Okay. That is extremely helpful. And just for clarity, in 2020, I think the average absorption was right around 30 or just a touch over. You think there is no reason, there is no constraints that you couldn't maybe hit mid to high-30s in an absorption rate over the next year or so?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

That's correct. We've done it before.

Truman Patterson
Analyst, Wells Fargo Securities LLC
Q

Thank you. Appreciate it guys.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

You're very welcome, Truman. Thanks.

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Operator: The next question is from Alan Ratner with Zelman & Associates. Please go ahead.

Alan Ratner
Analyst, Zelman & Associates

Q

Hey, guys, good morning. Congrats on the really strong results in this interesting environment we're in today. My first question, I was hoping to dig in on a little bit just thinking about [indiscernible] (00:38:10-00:38:16) activity. Curious if you could rank order, maybe some of the bottlenecks you're seeing that are leading you to take those actions. Is it more on the land side and kind of, obviously you're expecting big community count growth through the year, but you don't want to gap out earlier in the year ahead of the spring or is it more on the construction side and making sure that you have some accurate not only pricing on your costs inputs, but also telling your consumers a realistic delivery date? So I'm just curious if you could rank order those bottlenecks for us.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Alan, if you could repeat the first half of your question, it glitched out there.

Alan Ratner
Analyst, Zelman & Associates

Q

Yeah, sure. So, Marty, what I was asking about was when you think about those 15% to 20% of communities where you're intentionally slowing things down.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Okay.

Alan Ratner
Analyst, Zelman & Associates

Q

So I was hoping you could kind of rank order what the bottlenecks are that's causing you to take those actions. Is it land, is it construction, both?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

It is – I would say, number one is the length, the size of the backlog that is leading to the delivery date on the next homes sold being so far out that we need to bring it back. So if we are being so hot in a community to have a backlog that is so big, where the next home sold is getting a quoted delivery date of 12, 13, 14 months, even if it's a big complicated house, we would rather get that down at that community to 10, 11 months. And that means raising the price, slowing the sales until we get a little bit caught up where we can open things back up. That's number one.

Number two would be the sales have led us to get out ahead of land developments. And while we may have plenty of lots remaining in a community, we need to get the roads in, so that we have enough inventory of roads to build houses. We don't like selling a home if there is not a street in front of that lot, because that adds one more wrinkle where not only you just have to build a house for the client, but you have to get their road in for them before you can start building the house and there's weather delays and permitting issues and whatever else can be thrown at land development, where that adds a layer of risk as to when we can really deliver that home, if it's being sold without a road.

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So, we, and that's in limited cases, remember the entire extent of this concept of why allocation is 15% to 20%, most of that is driven by long backlogs, a lesser amount of that is being driven by land development needed to catch-up because of faster sales.

Alan Ratner
Analyst, Zelman & Associates

Q

Got it. Okay, that's helpful, Doug. And I guess kind of transitioning a little bit, but somewhat related, one of the pillars or one of the legs that you were kind of highlighting in the past as an opportunity to improve your returns is obviously inventory turnover and improving cycle times and I think that move to affordable luxury, the idea there was that over time could bring your company wide cycle times lower, obviously the environment from a labor perspective probably is a headwind in near term.

So, how are you thinking about ROE, you mentioned improving at 300 plus basis points, but are buybacks back on the table? Are there other things you could do, recognizing that perhaps cycle times is moving in the wrong direction, are there other things you could do to maybe accelerate that returning even more so in the near term?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, even in this tough market with trades being stressed and the issues that we all hear about with some materials like washing machines or windows were down one week in delivery and cycle time to build a home in Q3 to Q4 and affordable luxury is a bit more than 30 days faster construction cycle than our traditional luxury. And I am only committed, of course, I'm committed, it's my job, but I am seeing through our operations teams and we proved some of this, this last quarter with our tremendous results, the real strength in production.

And part of it is the affordable luxury line we brought in, some new builders that come from that background, that come from more production builders, part of it is this rationalization and optimization and curating of our plans, where less is more and the houses are simpler with less upgrades. So we are headed in the right direction. Now, there will be some headwinds with the labor issues that are going to come to the industry, but I'm really pleased with not only how affordable luxury is proving to be significantly shorter, but how our core business in itself is coming down also.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Other initiatives along that line, Alan, include putting more land under option, so we can buy it just when we need it, getting some seller financing, doing some land banking, again that gets us the land just when we need it, and in a few instances doing some joint ventures to develop the land often with other builder partners.

Alan Ratner
Analyst, Zelman & Associates

Q

And Marty, I'm just curious, buybacks, if you want to make a comment on that, since that has been a pretty big driver in the past.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

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We're very pleased with our liquidity position right now. It gives us significant flexibility, certainly buybacks, debt pay-downs and dividends are all on the table, our dividend increase is all on the table. But our primary objective is to grow the company through the land acquisitions, just [indiscernible] (00:44:23) and builder acquisitions.

Alan Ratner
Analyst, Zelman & Associates

Q

Understood. Thanks a lot guys. Good luck.

Operator: The next question is from Michael Rehaut with JPMorgan. Please go ahead.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Thanks. Good morning, everyone, and congrats on the results.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks, Mike.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

First question I had was, just kind of circling back to your comments around pricing and gross margins and obviously, very encouraging around the price increases that you're able to execute right now. Just wanted to make sure I understood properly some of the comments you made there. You talked about, [indiscernible] (00:45:01-00:45:09) $800,000, that would, you're talking about – little over $30,000 as well as many on a community level as well, at the same time, you are talking about $20,000 higher for the quarter.

Am I to think about it right that perhaps one or two of those occurred outside of fiscal fourth quarter and those are the price increases that should show up in back half 2021 margins, which here, kind of back in to it'd be like maybe up about 100 bps year-over-year. Are those the right ways to think about your prior comments?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yes, several of those – five, there have been five price increases this calendar year. In fact all of them – no, there was one in the fourth quarter, now there's one in the first quarter and the other ones occurred, one occurred in January when the market was hot, so the other ones have occurred before the fourth quarter or the one we're just mentioning. But again, those national increases, first of all, they're off a base price and they're not – they generally run, let's call it 1%, as a way of just continuing to move the company and sort of make that corporate decision, but the bigger part of this is the weekly discussions we have and decisions we make community by community to raise price.

I can't emphasize enough that that's really been the driver of where we've seen most of our price increases and we came out of, the early stages of the pandemic were not good to us. We didn't have $300,000 spec inventory for the renter to trade a similar monthly payment for running into ownership with rates. And so in March and April through mid-May, we were not seeing the results of the other big builders we're speaking off for the reason I just gave, and then mid-May, boy, did we see it coming, but we were careful in the beginning, because this was new, we didn't know how long it would last, and so our – for May and June, we traded, we took the sale and then in

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July, we started taking price, August we took more price, September we took more and it has accelerated into the second half of the fourth quarter, and now these first six weeks of Q1.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Okay. Thank you for that, Doug. Appreciate it. I guess, secondly, I just wanted to circle back to cash flow generation and uses of that cash flow. How we should be thinking about 2021, if you could just kind of review what your operating cash flow generation was this year and how you would expect 2021 to compare to that?

And again, you've obviously, you're going to be doing still a lot of investment in land and rolling out – growing your community count. And with your balance sheet where it is right now from a leverage standpoint, the share count guidance looks to be roughly flat, how any share repurchase may or may not play into your thoughts in the next 12 months, particularly as you had some accelerated share count repurchase or share repurchase prior to the pandemic?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, Michael, we think 2021 will be another positive cash flow year, significantly positive cash flow year, because of uncertainty in the world and the growth we're seeing, any buybacks are likely to be back ended, rather than if we were to do it similar to the prior year, where we did it in the front half, but as I mentioned previously, our first objective is to grow the company through land opportunities and builder opportunities. We have a bit elevated debt-to-cap compared to other builders. We have $420 million due next February, that's in the back of our mind. And so we want to maintain flexibility to address leverage, address buybacks, but mostly to buy land and builders.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Next February of 2022?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah, 2022, excuse me.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Right. Thank you.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're welcome.

Operator: The next question is from Anthony Pettinari with Citi. Please go ahead.

Anthony Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Hi, good morning. When you look at buyer urgency, are you seeing any meaningful difference in how consumers in your different regional markets are behaving or responding to COVID? I think earlier in the year you talked

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about community count maybe being 60/40 more insulated versus more impacted by COVID, just given cases are sort of surging nationwide. I'm wondering if you're seeing any regional differences that are noteworthy.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Early on, as we talked about, the Northeast was certainly hit harder, there was even construction shutdowns which affected production, but on the sales side, we were almost 100% remote for a long time and the sales centers were by appointment only or in some cases completely closed. Right now construction is thankfully open everywhere and we anticipate that will be the case.

We have gone to by appointment only in certain sales offices around the country, but it is not affecting activity. This is the second time for us, so we're better at virtual selling. The website has more videos, more photography, the sales teams are better, we're all better in Zoom and other ways of managing our live system.

I'm very confident notwithstanding some tightening of COVID restrictions and some stricter stay-at-home orders that we're going to continue to see good activity. I can't point to anywhere right now including California, which I know is very tight and Pennsylvania and New Jersey, where the governors have been extremely conservative and the rules are very tight. We're still seeing really, really good activity. So I think that certainly makes us feel good.

The active adult buyer, which has come back nicely, they could certainly be more cautious and maybe not venture out or certainly not get on an airplane to go to a destination active adult community for a couple of months. So I think that's a fair assumption. We haven't seen that dip at the moment, but I would not be surprised if that side of the business was to slow down a little bit, but overall, the other thing that's very interesting is, because people didn't travel as much for Thanksgiving and it doesn't feel like they're going to travel as much for winter holiday vacations, and because they're home working, the traffic during the week is higher.

We're not just selling homes on Saturdays and Sundays, when they're off of work. And we're selling – we sold a whole bunch of on Thanksgiving weekend. I mean many years ago, we were closed on Black Friday, now Black Friday is a big selling day, people are around, I think it's really changed. I mean, there's still going to be a spring season, I think mid-January to mid-April is still alive and well as a new home season, but I think the highs and lows have been changed, because people are staying in place a bit more. So I hope that answered it for you.

Anthony Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

That's very helpful. And apologies if I missed this in the remarks, but what level of land and development spend is implied in the outlook for 2021 or what degree of spending is necessary to hit your 10% community count growth goal?

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Anthony, we have all of that land owned or controlled right now. So it is not a significant expenditure to get that. I don't, off the top of my head know how many of those planned openings are controlled and require a bit of spend, but we have that land in our landbank.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yes, currently they are owned or in control for fiscal 2021 openings.

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Anthony Pettinari
Analyst, Citigroup Global Markets, Inc.

Q

Okay. That's helpful. I'll turn it over.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks.

Operator: The next question is from Mike Dahl with RBC Capital Markets. Please go ahead.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Thanks for taking my questions. First one, I wanted to follow up on the, kind of the pricing dynamics. I am just thinking about tracking kind of the all in pricing when you consider kind of the cumulative effect including local level and potentially even incentives are lot premium. So I think we've been tracking more in kind of like the mid, maybe even high single digits cumulatively over the past five, six months compared to, I'm not sure, if that like-for-like numbers is really comparable to that, those numbers you were talking about earlier. But is that the ballpark that seems kind of fair to you or do you think all in that like-for-like pricing?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

First, can I just ask if the, are we still distorted or are things better with the sound?

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Right now, better, but it's still a little tough the last couple of questions.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Apologies, I don't know if it's our end or if it's the conference call service, but we'll – sincere apologies on that. Our IT people are at least looking into our end, I'm not sure what happened. On your question, you're in the right ballpark. We have certain divisions that have had a bit of runaway price increases, that is significantly into double-digit and we've had other divisions that are lower, 1% 2%, 3% 4% range, but call mid-to-high single-digit price increases is right in the right ballpark.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Okay. Thanks, Doug. That helps. And my second question is going back to kind of the absorption comment and maybe just kind of a clarification, when we think about the potential capacity to do mid-30s or high-30s on absorption as you've seen in prior cycles. I guess, when I marry that with your comments about pushing price, limiting lot releases, is that actually the level of absorption that you view as optimal for today's positioning or is that simply just kind of a more theoretical capacity to sell that? I'm trying to understand where you would really look to run the business versus what the theoretical would be?

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Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Sure, yeah. I answered the question in the context of whether we can do better and sell more homes and actually deliver them. I'm comfortable getting this company on average to the mid 30s. Every division is different, the size of the homes dictates that, there are certain communities selling $2 million homes, where that would be difficult. There's other affordable luxury communities, where we could do 40. But I'm comfortable that we have the infrastructure to get up to the mid 30s and we're managing the business accordingly.

Mike Dahl
Analyst, RBC Capital Markets LLC
Q

Okay, great. Thanks a lot.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Welcome.

Operator: Well the next question is from John Lovallo with Bank of America Merrill Lynch. Please go ahead.

John Lovallo
Analyst, BofA Securities, Inc.
Q

Hi, guys. Thank you for taking my question as well. Starting with the base of 120 communities open in 2020 and moving to 150, 160 targeted this year, is there a rule of thumb that we can think about with incremental SG&A dollars, typically associated with each communities that they [indiscernible] .

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Well, I think the first rule of thumb is many of those dollars have been nine to 15 months before you see deliveries. As you hire a construction team and you hire a sales team that our site specific project managers, etc. I think the cost probably runs in the $50,000 to $75,000 a month range.

John Lovallo
Analyst, BofA Securities, Inc.
Q

Got you. That's helpful. And then maybe changing gears and thinking about capital allocation, one of the things that you mentioned a couple of times Marty was, the potential for strategic M&A. Curious when you think about that strategy, are you considering potentially moving – using this as a method of moving downstream in price point, perhaps buying a builder with a lower price point focus?

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

We've evaluated those opportunities. That is certainly something that we would consider, if it was the right builder in the right location and it added value to us. I think we've learned a lot about how to build affordable luxury, I mentioned bringing in construction teams and purchasing teams, which I didn't mention, but purchasing teams from bigger production homebuilders that are really good at counting every nail and every scrap of lumber that sits in a dumpster and so I don't think we need to buy a builder to learn the business and take their expertise from their local market to our national platform. I think we are now mature enough and have learned to not, but that is

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not – we don't need to pay a premium to do that. But if there is an opportunity to expand our business locally or regionally through an acquisition as you described, then we would certainly take a hard look.

John Lovallo
Analyst, BofA Securities, Inc.

Q

Thank you very much guys.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're welcome.

Operator: The next question is from Susan Maklari with Goldman Sachs. Please go ahead.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good afternoon, everyone.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Hi, Susan.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

My first question is thinking about the growth in the community count that you're expecting next year. Is there any color that you can give us in terms of the cadence of expecting those 150 or so communities to come online and anything we should be thinking about in terms of the geographic mix in there?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. Hold on one second, and we will get that for you. I love when your questions get into the weeds. I mean that genuinely.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

We're getting to that point in the call.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Okay. So the cadence looks good. It's a few less in Q1 and then Q2, Q3 and Q4 pretty even, call it sort of a 35 to 45 range of opening per community. The locations are spread throughout the country with strategically as you would think South and West having more as more and more people chase the sun and chase the jobs and the lifestyle. So there is less coming out of the Northeast.

There is less coming out of the Mid-Atlantic. Although, we're now at Atlanta, which will contribute a bit down there. And then there is quite a bit coming out of the South and the Mountain States in the West. So as I look this over,

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not only pleased with cadence, it's not all jammed into the fourth quarter and I'm very pleased with the geographic dispersion.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Okay, all right. That's helpful. And then my next question is around, there's obviously been a lot of inflation over the last couple of quarters, especially in terms of lumber pricing. Can you just maybe talk a little bit to how you are factoring that into the margin outlook? And how we should be thinking about inflation generally as we look to the next year?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, our costs are up $17,000 this quarter and it's all lumber. And as big a number that is I'm happy because it very short window, it was close to double that, maybe not quite double that, but it was a lot more and has come down nicely. So we've been very smart. We buy lumber as far out as we can, we have panel plants that are on rail lines, where we're buying the lumber right out of the mills, Pacific Northwest and the South, brings it right in on a rail car and drops it at our yard. We went to very short-term contracts on lumber nationwide, when the prices spiked. And so I'm pleased with how well we've managed these price increases, and obviously I'm pleased that it feels like it's beginning to come down and we hope continue to come down.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Our gross margin guidance reflects price increases to date, less budgeted increases in lumber and labor. It does not have a factor for inflation of price or inflation of labor, and it also impacts the negative impact of mix driven by the Pacific region becoming a smaller percentage of our total.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Okay. Got you. Thank you, guys and good luck.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you.

Operator: The next question is from Ken Zener with KeyBanc. Please go ahead.

Kenneth Zener
Analyst, KeyBanc Capital Markets, Inc.

Q

It's afternoon, so afternoon everybody. My question is going to be focused on your rise in cash flow, which is, it's tied basically to your lowered land intensity and gets offset by vertical investments. So my first question is units under construction, first backlog. Many builders report units under construction, which gives us a sense of how new your backlog is. So I don't know if you could – I don't think you've done it before, but if you could comment on how many units you have under construction? That's going to be the first question.

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And then for Marty, land efficiency, if you look at it, owned land it's down about 5% year-over-year, if you do it on a trailing supply basis. Is that a reasonable number to think about or I mean is there something that could drive that more or was there something unique, which led to your 5% improvement this year? Thank you.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

And I don't have a specific number for the number of our 7,800 homes in backlog that are under construction. I do know that our backlog is almost a month younger than normal based on when the sales happened this year versus the 10/31 year-end.

In terms of the owned land coming down, that is part of our return on equity strategy to get a bit more efficient. I think we don't necessarily want to see the owned land go below three years of supply. And so as we put more under option and don't buy quite as much and as our volume goes up, we are making progress in our land holding efficiency.

Kenneth Zener
Analyst, KeyBanc Capital Markets, Inc.

Q

Thank you.

Operator: The next question is from Jade Rahmani with KBW. Please go ahead.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Thank you very much. Question I usually ask, just wanted to see if you could give an update as to how much capital is invested in each of the multifamily and City Living businesses. There has been quite a few announcements on the joint venture side, and just wanted to see if you could provide an update for that?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Gregg, do you have that?

Gregg L. Ziegler
Treasurer & Senior Vice President, Toll Brothers, Inc.

A

I do. So it looks like here at year-end 2020, for the Apartment Living business, this is for our rental platform, our investment in that business is approximating let's call it $770 million and the good thing about that number is that we're actively spending a lot of time forming joint ventures to recoup our investment in those assets and bring them to market. So we're looking out over the next 12 to maybe 24 months, we'll probably bring $400 million back in via JV formations.

And then if we move on to our City Living platform, it looks like we have at year-end 2020, somewhere around just north of $400 million [indiscernible] (01:08:33) $410 million invested in that platform. And so, we usually like to break that out in to three categories for you, just so you have a sense of what that number means, and so our development assets are about $170 million, and then our land for future projects is about $200 million and then our joint ventures are about $40 million. Hopefully that helps.

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Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Yeah, that does. And just to clarify, the numbers you gave $770 million and $410 million, both of those are equity capital, not gross capital inclusive of debt financing?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Not inclusive of debt financing, right. That is our capital.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. And then just secondly, you said that spec sales came in higher than expected, I think last quarter it was 18% quick delivery homes. What was the percentage this quarter?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

For Q4 settlement it was 20% with spec settlements, 20% of total settlements with spec units.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

It was around 225 more spec units than in the third quarter.

Jade Rahmani
Analyst, Keefe, Bruyette & Woods, Inc.

Q

Okay. Thank you very much for taking the questions.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're welcome.

Operator: The next question is from Jack Micenko with SIG. Please go ahead.

Jack Micenko
Analyst, Susquehanna International Group, LLP (SIG)

Q

Hi. Kind of a follow-on to Jade's question. On the spec, I think you have said, 450 units will pull forward. Are you saying that 225 of those were spec? And then, I guess my question would be, when we look forward to the 2021 guidance, are you contemplating a higher mix of, I guess quick delivery or [indiscernible] (01:10:15) refer to them next year versus what we saw in fiscal 2020?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

No, we have less spec homes now, because of how rapidly they have sold. So, I think part of 2021 story is, as we mentioned the backlog is younger about almost a month younger than normal because it was sold in the second half of the year after the market picked up for us in mid-May.

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And so that makes the homes in backlog, just shy of 30 days younger than a typical year. Well, of course, that by younger, I mean, they are not as far along in construction on average as prior years, because they were sold a bit later through the lumpiness of the year. And we also anticipate having less spec deliveries, we will have many, but we will not have that – we do not expect to have that 20% we just mentioned, because of the very strong sales we've seen over the summer and the fall.

Jack Micenko
Analyst, Susquehanna International Group, LLP (SIG)

Q

Okay. That's helpful, guys. We won't see maybe the volatility in terms of delivery guide as much as we did this quarter. Doug, bigger question for you. Variable is commentary in the press release, some – we've messaged, we want to improve ROE by I think 350 basis points. Has capital allocation around the build versus the rental or City Living development changed, I mean it's hard to, you got to plan these things through cycles, given the construction timing, but is Toll pivoting more towards traditional, maybe less on the rental side. Are we hearing that or is it just maybe the way you fund that business, is going to change on a more pronounced basis?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

No, you're hearing that. We have no intention right now of buying a City Living property, that – there will come a time when that changes, but right now we're on the sidelines. We have, Gregg mentioned, $200 million of the City Living investment is in land and none of that land has started. So we have, what are really good high-rise sites, one in Manhattan, one in Philadelphia, one in Seattle and one in Los Angeles, that are not starting right now.

We need to get through this winter. We need to see what things look like in the spring. I am very encouraged by the last six weeks of activity in Manhattan. I'm not telling you it's back, but it is improving. We're hearing that buyers with the talk of vaccines are now thinking about living in New York. We're hearing a few stories of some that reentered the suburbs, that are coming back to take a look. But that doesn't mean I'm ready to start a high-rise in New York, because it's very different from the farm fields.

And the farm fields, when the market roles, you can just stop building the next house down the road. In the high-rise business, once you start, you're going, and you're going to the top. So we are being very cautious both in starting those four buildings I mentioned, and on the sidelines for new opportunities. On the apartment side, our business is good. Our locations are good, new apartments are holding up. Our rental rates, while they're down a little bit, are hanging in there. Our occupancy rates are up. Our delinquency rates have not moved.

So overall, while the business is good, we're being cautious. They're not frozen out, the way I call City Living at the moment being frozen out, but we're being the highly, highly selective on new opportunities under our Apartment Living platform until we have some more perspective and visibility on where the multifamily business is headed.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Yeah, we are asking the Apartment team to produce/digest what they have as quickly as they can before we look to many more future opportunities.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

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And Marty commented in the prepared script on our other income and joint venture income is guided down a bit in 2021 from what we talked about in prior years, and we have that income, it's in some really good stabilized apartment buildings, but we don't think right now is the time to sell those. If that time comes in the spring or the summer, we may surprise ourselves and all of you with some more other income for the year, but that's not what we are strategically planning right now. But we don't have to go out and find that other income, it's there, it will be monetized, it's just a question of when the best time to do that is, and we don't think it's right now.

Jack Micenko
Analyst, Susquehanna International Group, LLP (SIG)

Q

Appreciate the color.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome. Thank you.

Operator: The next question is from Matt Bouley with Barclays. Please go ahead.

Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

Good afternoon. Thanks for taking the questions. I have another one on the ROE. 2020 obviously a major disruption in the spring and you halted share repurchase, but the market did accelerate, closings grew. I imagine you mix further to affordable luxury. I think I heard you say earlier that the return profile is accretive to ROE, but ROE for the full year was still down.

So my question is, what were the biggest challenges to ROE in 2020? And as you look forward, I heard you discuss a lot of levers you're pulling, which of these levers, do you think are going to be kind of the incremental changes to ROE in 2021 relative to what was a challenge in 2020? Thank you.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

I think the challenge in 2020 was our gross margin, which came down from 2019 and was reflective of the sales environment that we saw 12 months prior and mix shift out of some of our really high margin California product. So that was the biggest challenge on return on equity in 2020. As we move forward, the pricing power we have is allowing us to drive volume and drive gross margin expansion that is improving our operating margin and improving our return, while at the same time we are carefully managing our equity through land acquisitions changing, product mix changing, and capital allocation.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

And on the land buying, which I think longer term will be the number one driver, I mean there will certainly be stock buybacks, there will certainly be dividends issued. We will certainly have strong markets for the – ROE is outsized, because of pricing power and great sales. But longer term, the primary driver is an obsessive focus on underwriting land deals at a high ROE, we call it ROI internally, return on investment is how operations works around here, a high threshold.

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And I'm unwavering on it. We are committed. It takes a while to turn a cruise ship, some of these deals that we approved now that have to get some entitlements or have to get some roads in and then open a sales center and sell a home and deliver a home, that can take some time, but it's common. And that I think from my perspective will be the number one long-term driver is, the discipline and the focus we now have on driving ROI through the underwriting of the next piece of land bought.

Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

Got it. Okay. That's very helpful color. Second one I had was just on the closings guide. I think I heard you say earlier that 60% of deliveries will be in the second half of the year. And I think that number is maybe a little elevated, but it's not particularly unusual relative to prior years for Toll.

So I'm just curious, just given what we're seeing in labor and cycle times, is the expectation that even within that I don't know if you can get this detail, but should it be even more Q4 weighted than usual or is that kind of typical cadence of closings still the right way to think about it? Thank you.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

I think Q4 weighted is the right way to think about it, particularly based on the rapid increase in sales we just had in the existing Q4.

Matthew Bouley
Analyst, Barclays Capital, Inc.

Q

Okay. Thank you, Marty. Thanks, Doug.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're welcome.

Operator: And the last question comes from Alex Barron with Housing Research Center. Please go ahead.

Alex Barron
Analyst, Housing Research Center LLC

Q

Yeah, thanks guys. Appreciate it. Good job. I wanted to, sorry if I missed this, but the margin guidance in the first quarter, was that just related to the market conditions when you took those orders back in the spring.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yes. March, April, half of May.

Alex Barron
Analyst, Housing Research Center LLC

Q

Okay, got it. And then my second question was, as we've been shifting the product mix to the more affordable luxury, have you guys been able to shorten, I guess, the delivery cycle, because on the guidance it wouldn't appear so, but maybe in business and something?

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Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah, we had said earlier, Alex, that it's taking 30 days less to build the more affordable luxury homes. I hope that even gets better, but that's what the number is right now.

Alex Barron
Analyst, Housing Research Center LLC

Q

Have there been any other offsetting factors like taking longer to get a permit or something else?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

No, actually. It's shorter because our clients don't go spend 30 days in a design studio and figure out how they can spend a couple of hundred thousand dollars on Portuguese tile.

Alex Barron
Analyst, Housing Research Center LLC

Q

Got it. Okay. Well, best of luck for 2021. Thanks.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you. You're very welcome.

Operator: 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, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

Gary, thank you very much. Thanks everyone for your interest and support. Have a wonderful holiday season and I hope when we speak next, we're in more sensible times. Thanks all. Take care.

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

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