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Toll Brothers, Inc. (TOL)

Q2 2021 Earnings Call

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CORPORATE PARTICIPANTS

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

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

OTHER PARTICIPANTS

Christopher Kalata
Analyst, RBC Capital Markets LLC

Stephen S. Kim
Analyst, Evercore ISI

Michael Rehaut
Analyst, JPMorgan Securities LLC

Alan Ratner
Analyst, Zelman & Associates

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Truman Patterson
Analyst, Wolfe Research LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Toll Brothers Second Quarter Earnings 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] The company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourself to one question and one follow-up. Please note this event is being recorded.

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

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

Thank you, Drew. Welcome and thank you for joining us. 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 begin, I ask you to read the statement on forward-looking information in our earnings release of last night 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 pandemic, interest rates, inflation and many other factors beyond our control that could significantly affect future results.

I'm very pleased with our second quarter results as we beat our guidance on nearly every metric. We delivered 2,271 homes for record second quarter homebuilding revenue of $1.84 billion. Our adjusted gross margin of 24.4% increased to 150 basis points year-over-year and was 100 basis points above our guidance.

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SG&A as a percentage of homebuilding revenue was 11.9%, an improvement of 190 basis points year-over-year and 110 basis points better than guidance. Pre-tax income of $169.8 million and EPS of $1.01 per share increased 66% and 71%, respectively, compared to the prior-year period.

Contracts and backlog in both dollars and units were all-time record. Our backlog at quarter end was valued at $8.7 billion on 10,104 units, up 58% in dollars and 57% in units compared to last year. We signed 3,487 net new contracts for $3.1 billion in the quarter. On a year-over-year basis, our net signed contracts in the second quarter were up 85% in units and 97% in dollars.

As a result of our excellent results in the quarter and based on the significant visibility our backlog provides, we are raising our full year guidance on nearly all key metrics. We are increasing our full year 2021 projected home deliveries by 100 units to 10,300 at the midpoint. And we now project return on beginning equity of 14.5% for fiscal year 2021, representing a 570 basis point improvement over 2020.

Our strong order growth, coupled with significant and consistent price increases, sets the stage for meaningful revenue, earnings, margin and ROE growth in fiscal year 2022. While we're not providing formal guidance for 2022 at this point, we believe our 2022 return on beginning equity is expected to exceed 20% and that our gross margin for 2022 will significantly exceed fiscal year 2021's gross margin.

Demand remains very strong. We continue to raise prices in nearly all of our communities during the second quarter and into the start of our third quarter. We also continue to strategically moderate sales paces by limiting monthly lot releases to two to four lots per community. We have steadily expanded this allocation strategy to now cover about two-thirds of our communities, up from about one-third in January 2021.

For communities that are on allocation, we raise prices as we release lots to a priority list of high interest buyers or through a competitive sealed-bid process. This allows us to maximize price and, therefore, margins and align our sales pace to a manageable level of production. We are very pleased with the effectiveness of this strategy.

For the three weeks ended May 23, non-binding reservation deposits were up 19% over the comparable period last year. The market did not dictate this 19% deposit growth, we did. We will continue to evaluate the number of communities on allocation to balance profitability and growth.

We believe the housing market is positioned for sustained strength, driven by the long-term supply/demand imbalance resulting from the past decade of underproduction of new homes, low interest rates, a tight resale market, favorable demographics, especially as millennials enter their home-buying years, migration from higher cost metropolitan markets into attractive more affordable markets enabled by the remote-work trend and the greater overall appreciation of one's home that has emerged over the past year, and an improving economy. All of these tailwinds should be here for some time and sustain the strong housing market.

Toll Brothers' customers specifically are also benefiting from the strong stock market and rising existing home prices. Our buyers who have a home to sell are confident they can sell it quickly and at an appreciated value. We are seeing an increase in demand in markets like Boise, Reno, Vegas, Austin, Phoenix, Denver, and all of Florida from buyers who are migrating out of higher cost coastal markets. These relocating buyers are not experiencing affordability issues as we raise prices.

The shift to more permanent work-from-home arrangements means our customers increasingly want to personalize their homes to fit their evolving lifestyle. The design choices we offer is a distinct competitive advantage. This quarter, our buyers added on average $162,000 or approximately 24% of the base price in lot

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premiums, options and upgrades. This is up from our long-term average of about 21%. These features and upgrades are generally accretive to gross margin.

While the strength in the housing market has been well documented, so too are cost increases for materials such as lumber and copper. To-date, we've been able to more than offset these cost pressures with price increases. And our gross margin projections for this year and next reflect our confidence in our ability to continue managing costs.

At quarter end, we owned or optioned approximately 74,500 lots. Our strong land position provides a firm foundation for outsized growth over the next several years and we are currently benefiting from the significant percentage of our land that was put under control at pre-pandemic prices.

Notwithstanding our 85% order growth this quarter, we met our Q2 guidance of 320 communities at quarter end. And while we project community count to drop to 310 at the end of our third quarter, due simply to the timing of certain community sell-outs and openings, we continue to project 340 communities at fiscal year end. We also reaffirm our guidance for 10% community count growth in fiscal 2022, and this guidance is based solely on the land that we already control today.

Our strategic expansion into new markets and products, especially the affordable luxury niche, has positioned us well for growth. We now operate in over 50 markets in 24 states with communities in both high-growth and high-barrier-to-entry markets.

We offer the widest variety of homes in the industry, appealing to growing families and affluent customers with our luxury move-up homes as well as to millennials and first-time buyers with our expanding, affordable luxury business; and for baby boomers, our active adult communities. This product and market expansion has helped fuel the increase in our backlog to record levels.

For example, in the 12 months ended April 30, 2021, nearly 16% of contracts were from markets where we had no presence five years ago. This is up from approximately 6% in the comparable period last year. First-time home buyers, who are primary buyers in our affordable luxury market, accounted for 30% of our deliveries this quarter compared to 25% one year ago. We have also seen our active adult segment strengthen with the rollout of vaccines. Orders in our active adult segment were up 135% compared to the second quarter of last year.

With our increased focus on capital efficiency, a record backlog and expanding gross margins, we are projecting ROE growth this year and next with fiscal year 2022 ROE expected to exceed 20%. We believe this growth is sustainable due to actions we have taken in many aspects of our business. This starts with the structural and permanent changes we have made to how we acquire and develop land.

As we have discussed over the past 18 months, we have totally revamped our land underwriting standards to require higher risk-adjusted returns. We have also increased the amount of land that we acquire through more capital-efficient structures like land banks, joint ventures, seller financing, and other strategies that allow us to option more land.

At second quarter end, the percentage of lots that we optioned versus owned grew to 49% from 46% at the end of the first quarter and 40% one year ago. Since we have just about met our previously announced 50/50 target, we are now updating our target to 60% optioned land and 40% owned. Our focus on ROE also includes our expansion into more affordable luxury homes, which can be built more quickly and efficiently on less expensive land.

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Additionally, we are improving ROE by returning capital to shareholders through share repurchases and dividends. Since fiscal 2016, we have bought back approximately one-third of the outstanding shares at an average price of $37.20. And in April, we increased our quarterly dividend by 55% to $0.17 per share. These actions reflect our confidence in the sustainability of our substantial cash flows moving forward.

We project approximately $750 million in cash generated from operating activities this year. Our highest priority for capital allocation continues to be investment in the growth of our business, whether through disciplined land buying or strategic home-builder acquisitions, followed by returning capital to shareholders and reducing our leverage. As we enter the second half of our fiscal year which historically has been when we generate the majority of our excess cash flow, we expect to be more programmatic in our stock repurchases.

We are also committed to improving the capital efficiency and earnings consistency of our City Living and Apartment Living businesses. With respect to our City Living urban condo business, we are very pleased with the renewed demand coming out of New York City where we signed 44 contracts in our second quarter, including 27 at 77 Charlton in West Soho, up from 33 total for all of the City Living business in the first quarter of 2021.

Going forward, we intend to develop most of our City Living buildings off balance sheet in joint ventures with project-level financing. We expect this to significantly reduce the amount of capital committed to the City Living business and improve return on equity.

Our Apartment Living platform is performing very well. We recorded a $10.7 million gain on sale this quarter and expect more through the balance of the year, while we recognize that this business can also be an inconsistent contributor to earnings and thus ROE. As we have mentioned before, we are monetizing some of our land in this business through joint venture formations, and going forward, we intend to defer closing on any new land for the apartment business until third-party equity and debt capital is committed.

Additionally, we are likely to increase the number of projects that we sell at stabilization versus holding longer term. These new strategies should make earnings more consistent and improve ROE.

Now, let me turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. Good morning, everyone. We had a terrific quarter. Our business continues to fire on all cylinders, especially our production teams out in the field. We delivered 2,271 homes at an average price of approximately $809,000, generating record second quarter homebuilding revenue of $1.84 billion.

Deliveries were up 18% in units and 21% in dollars compared to one year ago. Our second quarter pre-tax income was $169.8 million compared to $102.1 million in the second quarter of 2020. Net income was $127.9 million or $1.01 per share diluted compared to $75.7 million and $0.59 per share diluted one year ago.

It's important to note that our second quarter pre-tax net income included a $34.2 million pre-tax charge, or $0.20 per share after tax, related to the early redemption of debt. Without this one-time charge, earnings per share would have been $1.21.

Second quarter adjusted gross margin was 24.4% compared to 22.9% in fiscal year 2020's second quarter and 100 basis points better than projected. The outperformance was due primarily to pricing power, higher margin

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option sales, favorable mix, operational efficiencies and cost controls. Looking forward, we are now projecting adjusted gross margin for full year 2021 of 24.6%, up 30 basis points from prior guidance.

Despite recent increases in material and labor costs led by lumber prices, we are confident in our adjusted gross margin projection for the second half of fiscal year 2021 and our ability to further expand it in fiscal year 2022. With new home demand far outstripping supply, we have been able to push prices, which has more than offset cost increases.

We are intensely focused on our construction budgets and managing building costs. Before we build any of our homes, we have contracts in place for substantially all of our components and trades, and we develop conservative budgets that include a significant contingency on top of our contracted costs.

When input costs rise and our trades request price increases, our first priority is to protect the margin of the homes in our backlog where sales prices have already been set, and to postpone negotiating those cost increases to the next home sold. We have generally been successful with this strategy due to our strong relationships with our trades and our operating scale.

I'd also point out that our expansion into affordable luxury has made us a better, more efficient builder at all price points. The efficiency required to compete at lower price points has driven us to optimize the designs of our homes and adopt more streamlined construction processes.

We've taken these practices and lessons learned to all of our product lines, which has made us a linear, more efficient production-focused builder. Importantly, as we have optimized our plans and refined choice for our customers, we have improved their customer experience.

In addition, we have been fine-tuning our strategy related to our spec homes. On average, 15% to 20% of our deliveries each year are built on spec. Our strategy is now to delay selling these homes until we reach at least 50% completion, allowing us to maximize the price at which we sell these homes. All of these factors give us confidence in the gross margin in our backlog and our projections for the remainder of this year and into next.

Turning back to our second quarter results, as Doug mentioned, SG&A as a percentage of revenue in the quarter was 11.9% of revenues, 190 basis point improvement over the prior-year period and 110 basis points better than our guidance. We attribute this primarily to leverage resulting from higher revenue and continuing impact of the cost savings initiatives taken in 2020, reductions in advertising spend and our relentless focus on controlling overhead.

Joint venture, land sales and other income was $21.5 million in the second quarter compared to $16 million in the same quarter last year and our projection of $7 million. The better-than-expected performance here was due to the sale of an apartment building in suburban Atlanta that had been projected for our third quarter.

In addition, our mortgage and title operations were more profitable than projected. Our balance sheet remains strong. We ended our second quarter with approximately $2.5 billion liquidity, including $715 million of cash and $1.79 billion available under our $1.9 billion revolving bank credit facility.

In the second quarter, we invested approximately $430 million in land and acquisition and development. We also redeemed $250 million of our 5.625% notes due in 2024 in the quarter, which resulted in the $34 million charge I noted earlier.

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In total, in the first half of fiscal year 2021, we retired approximately $440 million of debt and have reduced our debt-to-capital ratio at quarter end to 42.2% on a gross basis and 35.6% on a net basis compared to 43.8% and 35.8%, respectively, at the end of the first quarter of fiscal year 2021. We continue to target a net debt to capital ratio in the high-20% range by fiscal year end.

We also continue to project approximately $750 million in cash generation from operating activities in fiscal year 2021. As Doug noted, we'll continue to use our cash to invest in the growth of our business with excess cash returned to shareholders and used to further reduce our financial leverage, including repaying $410 million of our 5.875% public notes that are due in February 2022, when they become callable at par in mid-November 2021.

As we look forward to the second half of fiscal 2021, we are increasing our guidance for nearly all key metrics. We now expect full year deliveries of between 10,200 and 10,400 units with approximately 2,675 to be delivered in the third quarter. Our third quarter deliveries guidance reflects the slow COVID-impacted sales environment from mid-March to the end of May in 2020.

We estimate an average delivered price for the full year of between $805,000 and $825,000 per home. This is up $15,000 at the midpoint compared to previous guidance. Average delivered price for the third quarter is expected to be between $820,000 and $840,000.

As I mentioned earlier, we project adjusted gross margin of 24.6% for the full fiscal year, up from our previous projection of 24.3%. We expect adjusted gross margin to be approximately 24.8% in the third quarter, which implies a fourth quarter margin of 25.4%. We expect our gross margin to grow further from Q4 in fiscal year 2022. As Doug said, we have increased our projected return on beginning equity for fiscal year 2021 by 570 basis points to 14.5% and we expect it to exceed 20% in fiscal year 2022.

We expect full year interest and cost of sales to be approximately 2.4%, which is also what we expect in the third quarter versus 2.5% in fiscal 2020. As a result of debt reductions I discussed earlier, we expect this interest expense to continue to decline in fiscal 2022 and beyond. We expect SG&A as a percentage of revenue to be approximately 11.8% for the full year and 11.6% in the third quarter.

In addition to revenue leverage and the ongoing benefit of past cost saving actions, we expect the benefit from lower sales commissions that we're now paying to outside brokers. We expect community count to be 310 at the end of our third quarter and 340 at fiscal year end with an additional 10% growth in community count by fiscal year end 2022.

Our full year guide for other income, income from unconsolidated entities and land sales gross margin is now $110 million for the full year, up $30 million from our prior guidance, with approximately $20 million projected for the third quarter. The increase is primarily due to greater profitability in our mortgage and title operations, along with gains we are projecting from the sale of an additional Apartment Living project this year.

Now, let me turn the call back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. To wrap it up, we continue to believe that with our strong land position, our plans to grow community count this year and next and a wide variety of homes that we offer in 24 states in 50 markets, we are very well positioned to capitalize on the extraordinary demand we are seeing in the housing market.

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And with the structural changes we have made and continue to make in how we operate, including our relentless focus on capital efficiency, returns and internal operating efficiencies, we believe that our results will continue to improve in both the short and long term.

Before I open it up to questions, I want to remind all of you of our upcoming Virtual Analyst and Investor Day that we'll be hosting next Wednesday June 2, starting at 11:00 AM Eastern Time. We will showcase many of our team members, products and our communities, and you will become much more familiar with our operations and our culture. And we hope you will come to understand what makes Toll Brothers such a special company and how much we've evolved in the past decade. I'm really looking forward to it and I hope you'll be able to join us on Wednesday.

I'd also like to encourage you to take a look at our recently released ESG report, which is now available on our website. This is our first report and it includes important information regarding the many initiatives we have taken with respect to ESG.

And finally, I'd like to thank all of our Toll employees for their contributions to our great results this quarter. We couldn't have achieved these results without your hard work, dedication and commitment to providing our customers an experience unmatched in the homebuilding industry.

With that, Drew, let's open it up for questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. As a reminder, the company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourselves to one question and one follow-up. [Operator Instructions] The first question comes from Mike Dahl with RBC Capital Markets. Please go head.

Christopher Kalata
Analyst, RBC Capital Markets LLC

Q

Hi, this is Chris Kalata on for Mike. Thanks for taking our questions. My first question is just on the assumptions behind the greater-than-20% ROE expectation for 2022. Obviously, the strength in sales and margins are driving much of that improvement, but are you assuming any benefit, if at all, on buybacks or benefits from balance sheet repositioning?

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

A

I think there is modest benefit assumed from that. The big drivers of that expansion in ROE are revenue growth and gross margin.

Christopher Kalata
Analyst, RBC Capital Markets LLC

Q

Understood. And I know you guys said you didn't want to provide 2022 guidance, but I know last quarter, you guys spoke to expecting gross margins above 25% in the first half of the year given the strength and the exit rates expected this year. Any update you'd be willing to provide on what you're expecting specifically for the first half on gross margins?

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

A

I think, in the prepared remarks, I mentioned that our – the math leads you to 25.4% as the gross margin for our fourth quarter, and we expect it to be higher than that in 2022.

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

A

And I'll refer you, Chris, back to my comment, in my prepared remarks, when I said our gross margin for 2022 – and I'm reading – will significantly exceed 2021.

Christopher Kalata
Analyst, RBC Capital Markets LLC

Q

Understood. Fair enough. Thanks for taking my questions.

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

A

Thank you.

Operator: The next question comes from Stephen Kim with Evercore ISI. Please go ahead.

Stephen S. Kim
Analyst, Evercore ISI

Q

Yeah. Thanks, guys. Appreciate all the color. Exciting times out there and a lot of changes in terms of the way builders are pricing, given the scarcity of supply. And you all have, obviously, got a lot of experience with selling scarcity to your customer base. But the auctions and sealed bids that we've kind of been hearing about as well as some builders putting in escalators for potential increases in cost, one of the things that I've gotten from builders when they talk about those strategies is that they are concerned about the customer service blowback that implementing some of these things may generate.

I've got my own views on that. But I would be curious if you could explain how you think about any potentially negative ramifications from changing – altering the way in which you price versus the past. And then, specifically with respect to escalators – cost escalators in your sales contracts, is that something that you guys actually are doing or would consider doing or not?

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

A

Great question, Steve. I look forward to the days when we are able to sell everybody who wants a home one of our beautiful homes, but that is not today's market. And there's precedent set, of course, in the resale market, when things are hot for – the five of you have made an offer, by tomorrow night at 5:00, we need your final and best in an envelope. And so, that occurs in the housing market.

We, as I mentioned, have now gone on allocation in two-thirds of our communities because of just significant, significant demand that far exceeds our ability to sell – or our desire to sell, frankly, because we want to manage our growth with 58% up in backlog. And our construction teams are doing a fantastic job out there, but it is time to start taking price and managing operations, managing demand and managing growth.

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And so, what we have done in our communities that are on allocation is basically two things. Some communities have been taking a list. And by the way, the people on that list have been prequalified for a mortgage and they're ready to go. And if we've given people a number on the list, Mr. and Mrs. Smith is 20 on the list and you're number seven, and at the pace we're going we think we're going to get to you in the month of July, or whatever it may be, that's one way. And then, every couple of weeks when we offer a couple of lots, we raise the price. And we may raise it $50,000. It just depends on the community.

The way we've now migrated, not in all cases, but in many, is those people on the list that are number 7, 12, 20, 32, say what the heck, you've taken my destiny out of my hand. You've taken the opportunity for me to buy a home away, because you're not going to get to me for so long. How about the resale market? Give me the chance, like they do, to give you a sealed envelope with a number. And we actually have seen more people accepting of that because they can control their destiny than the people that are further down on that list and we may not get to them for a while.

It's a balancing act. And I'd say, it's probably right now 50/50 between working off of a VIP list in a particular order and going to final and best sealed bid. Now, you may ask, with 80% of your business being to be built, how do you do that? It's easy when you have you a spec house. You just put the house on the market, give a base price, and tell them to give you an envelope. We've figured it out. If we're going to open up two or three lots on a weekend, we have our price sheet of the base price of all of the homes that you can buy from us, we have the price of the structural upgrades and, of course, we have a design studio where you can go and buy your finishes.

So, we bid the lot premium. We tell the clients two lots are opening up this Saturday. The minimum lot premium is $25,000. And put in your price for the lot premium. And if you win, you can then still have all the choice and the special sauce of Toll Brothers, because you can then pick your home off of our price sheet at our base price and you can then go through your own upgrade program. And so, that's how we're doing it. I am confident we are treating the client well. We are communicating with the client and it's working. And it's maximizing price and it's controlling growth as we want to.

As to your question about escalators, no, we are not adding escalator provisions to our contracts. Sorry for the long answer, but I know it's an important question and I wanted to give a detailed answer for you.

Stephen S. Kim
Analyst, Evercore ISI

Yeah, that's great. Really appreciate that, Doug. The second question relates to margins, and particularly what I'm talking about is not margins in the third quarter, but really what the margin opportunity is as you look forward, assuming that the current environment doesn't dissipate very rapidly for whatever reason. When I look back in history and I look at, let's say, the 2003 to 2005 period, which was probably the most analogous time to today in terms of pricing. Obviously, the bone structure was much worse back then than it's today.

But pricing back then in the industry was, call it, got to 15%. We're now running 25% year-over-year in the resale market. So, we're running much hotter than we were even then. In that period of time, your gross margins went up about 670 basis points. And I think people may have forgotten that. And I know that there are some things that would work against you from achieving something like that over the next couple of years. The ones that come to mind are your increasing affordable luxury focus as well as the material cost inflation that you're fighting against, but probably still incurring to some degree, and possibly a change in your land investment, just sort of trying to go to a more just in time.

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So as we think about what you saw during that period of time in terms of pricing and the margin impacts, and you assess these three things that I laid out that are sort of drags to your margin, can you dimensionalize some of those for us and help us understand how significant some of these headwinds theoretically might be to margin expansion versus the opportunity from price?

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

A

Sure. Let's start with land, yes, as you can tell by our prepared comments and what we've been talking about lately, we are structurally changing how we buy land. We are very, very focused on ROE. I know it's shining through and we're proud of it and it will continue and it's permanent. Right now, those 70,000-plus lots that we control, and I mentioned it, most of those lots were controlled, were put under contract pre-pandemic before prices ran. So, we're in a really good position where we can be selective in how we grow the land bank. And I think that is not maybe the headwind you suggested as much as it would appear for that reason.

Affordable luxury, which is a growing part of our business and we thought would be lower margin in our luxury business, is not. Because of the strength of that market, because of the 70 million-plus millennials coming out, the affordable luxury margins are right there with our core luxury business. Our move to the south, our move to the Mountain States has helped, has been a tailwind to margin, because those are growth areas in this country, we've had pricing power. And while one would think you go to Tampa, you go to Jacksonville, you go to Atlanta, you're going to have a little margin compression, not the case because of the strength of those markets and how this country is migrating. And the Pacific, California, Oregon and Seattle, there's 40 million people in California, they're not all leaving. We are seeing tremendous growth, 80% plus, or 85% order growth Q2 coming out of California with significant pricing power.

So, I'm not going to comment historically on what happened to gross margins. Thank you for being with us for that length of time. I remember those good old days. But we are certainly feeling strong tailwinds. I'm not going to speculate on where lumber goes, but Marty talked at length about how we are fully budgeted with contingencies for the building costs that have been rising. We also push back with our trades. If a plumber wants a price increase, it's not fair that he asked for it on a housing backlog. We sold that house to that client with that plumber's contract in place, and he will honor that contract for that price. If we need to talk about an increase on the next home sold that we can then properly budget for, that may be a fair conversation. But we fight hard to protect that backlog, and it's working.

Stephen S. Kim
Analyst, Evercore ISI

Q

That makes a lot of sense. Thanks, Doug. By the way, I misspoke. It was 670 basis points on the operating margin, not the gross. That's what I meant, but thanks for the fulsome answer. Really appreciate it.

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

A

Very welcome. Thanks, Steve.

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

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

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

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

A

Hi, Mike.

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

A

Hey, Mike.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Hi. So, I wanted to – my first question, I guess, I found it really interesting around the relocating buyers and in different states how that helps with consumers accepting price increases, perhaps, coming from higher cost states to lower cost states, or coastal to inland. I was curious if you track any of those back, for example, out-of-state buyers in Florida or some of your inner western markets relative to California. And how that might have changed – has changed over the last year or two?

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

A

Sure. We do track it as best we can. And in those markets that are seeing more and more of the northeasterners and the Californians – and that's not the only migration, right, but those are the two big ones. You've got the Boston to Washington D.C. corridor that's moving south or moving west. Then you've got the Californians who are – they're moving to east somewhere because there's nowhere to go west. We're at about 40% of our sales in those accepting markets are people coming from what I just mentioned. Now, there's some markets that are 50%, 60%, there's others that may be lower. But that's, call it, about almost half, right? Just shy of half of the buyers are coming from out of state.

And the phenomenon is fascinating. We've never seen migration like this. It obviously caught wind early in the pandemic when people thought they would be working in their sweat pants from their kitchen table forever. But it's continuing as people now realize that, well, maybe I'm not at my kitchen table every day of the week. But Austin, Texas, the pricing in Austin, which is – the pricing power of Austin, which is number one in the country, is driven by California, plain and simple. The pricing power of Boise, Idaho, of Reno, of Phoenix, of Vegas, of Florida, where we're in Charleston, we're in Greenville, South Carolina, Atlanta, Raleigh, Charlotte, just it's the obvious market, Denver. I mean this can go on and on. I need to cut it off here.

So, they're moving from areas that are very expensive. The homes are expensive, the taxes are high. And it's giving us more power to raise the price without affordability issues being apparent. The traffic is holding up. Yes, a year ago, could the California have gotten one of our homes in Boise for $400,000 and is it now $600,000? Yes, but it's $1 million house they're trading out of in California or maybe it's $1.2 million now and it was $1 million a year ago, and their monthly payment is so much less because of the tax structure. So, we're very happy and we're benefiting from these migration patterns from expensive to less expensive.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

All right. That's helpful, Doug. And it's a really fascinating pattern that, I think, has accelerated, as you're pointing out. I guess, secondly, I just wanted to shift a little bit to ROE and the goal that you have set for 2022. You mentioned earlier, Marty, that the big ROE drivers or improvement drivers to be revenues and gross margin. You also mentioned earlier at some point in the talk that – in your prepared remarks that you're going to become more

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programmatic on your stock repurchases. Just wanted to get a sense, if possible, what you mean by programmatic?

I mean I think that points – the stock repurchases over the prior couple of years have been somewhat sizable one quarter, then more modest in subsequent quarters. Should we be thinking about maybe 1 million or 2 million shares per quarter here, something on that type of a run rate or any type of rough annual spend? Any type of directional guidance would be helpful.

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

A

Sure. Mike, we are focused on return on equity and shareholder value now more than ever before. And the rough magnitude you outlined of 1 million to 2 million shares is probably a good entry point, particularly as we look at, I'll say, quarters other than the first or second, when we're generally using more cash in operations. And conversely, Q3 and Q4 is when we generate a lot more cash. So, we're going to maintain some flexibility. We've been opportunistic in the past. We're going to be more programmatic in the future.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Great. Thanks very much.

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

A

You're very welcome, Mike.

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

Alan Ratner
Analyst, Zelman & Associates

Q

Hey, guys. Good morning. Thanks for taking my questions.

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

A

Hey, Alan.

Alan Ratner
Analyst, Zelman & Associates

Q

Doug, first, I'd love to maybe just expand a little bit on the out-of-state buyer topic. So, very interesting the data you gave there. First, I'm curious, I might have missed it, but the 40%, 50% number you gave kind of where that's running at today, what was that pre-COVID? And I guess, the follow-on to that would be, I'm sure it's a little bit difficult to look at this on a weekly or monthly basis. But now that offices are starting to open back up in the northeast and schools are not going to be remote in the fall, have you heard any chatter about that trend slowing any bid on the margin more recently?

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

A

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So, Alan, your first question, about 30% pre-COVID in Florida, some of these markets I mentioned that have been, for some time, accepting out-of-staters, because of – back then, it was more – it was lifestyle in Florida, but places like Austin would have been tremendous job growth. So, let's call it 30% to just shy of 50% is probably the move from pre-COVID to today. And you would think that we would see less migration for the reasons today than nine months ago for the reason you just described, and we are not.

Alan Ratner
Analyst, Zelman & Associates
Q

Got it.

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

And I don't have a great answer as to why that is. I think people, for example – and I'm of the age where you start thinking about where is the retirement home going to be. And I just know so many people that are doing that earlier. And they're doing that while they're still working, because they want to set it up at 55 instead of at 63. And they know they don't have to be in – on Wall Street every day of every month and they can figure out it's going to be a week in Florida. I'll fly back for the next week, but I'm going to begin to set up the next phase of my life.

So, I think part of that is why this continues to sustain itself even as people go back to work. I know our company. While we are going – we believe we are better when we are together, and that's become a tagline of Toll Brothers as we begin to come back together, we of course will be flexible. We're not going to be able to hire people and retain people unless we show some level of flexibility. And so, I think people recognize that in most companies. And therefore, I think this migration pattern to live where you want and not where you're tethered is continuing.

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

I also think, Alan, you're seeing more companies move their operations to lower cost of operations areas. The migration of corporate headquarters to Texas is well documented. And I think you're also seeing companies, while they may not move the headquarters, they see where the people are going and they'll move a back office or a support function to that area, so people can be in an office, if not the headquarters office, as part of their workday.

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

Right.

Alan Ratner
Analyst, Zelman & Associates
Q

Got it. I appreciate those thoughts. Second, I'd love to drill in a little bit more on the shift in your spec strategy, because I think this is going to be something that's really interesting to track over the next few quarters. So, I know you're not a big spec builder to begin with, but even kind of delaying the sales of some of those homes, I would imagine, at some point later this year you're going to have more specs coming to the market that are closer to completion. And I think the shift has probably been even more dramatic from some other builders. I mean, some builders that are primarily built-to-order builders have completely shifted their sales strategies and are effectively building up spec homes and will release those later in the year. And in addition, you guys are talking about 10% community count growth between now and the end of the year, and other builders are as well.

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So, I'd love to hear your confidence and your thoughts about what the pricing power will be later this year when it seems like as this shift in sales strategy unfolds and you have more inventory coming to the market, recognizing that there is a ton of demand today, but do you think the pricing power will still be as strong as it is today once all of the – these new communities and specs ultimately get listed for sale?

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

Yeah. So, you're not going to see what you describe as a larger number of finished specs coming to market later in the year. We actually had 1,500 specs, and we define a spec – actually, we don't – we hate that word around here. It's a QMI, quick move-in. We had 1,500 QMIs last year, and that's defined as framing has begun, and we have 1,000 today. So because of how hot the market is, we are actually undersupplied at the moment, but we are catching up, because we are forcing and requiring all divisions to build QMIs into their backlog every month.

And so, I think it will be fairly consistent. And I'm not worried about all of a sudden a lot of finished homes come to the market and, oh boy, I hope the market's still in good shape. I think it's formulaic. I think it's progressive, and I think it's fairly consistent in the number that we're starting, the number that we're selling. We'd sell a spec at frame. But not today, because to sell a spec at frame, the market is so hot, somebody that truly wanted a new home, custom designed, well, if all they can get is a house at frame where they can't do the custom design or the structural changes, they can only go to the design studio for the finishes, they're going to grab it.

And we would rather have those people wait their turn to buy the new home and save that spec home until it is beyond drywall. Obviously, we know every single cost at that point without any issue. I mean I already gave the story of how we push back on the plumber that wants a price increase on backlog. But if the house gets beyond drywall, we're in fantastic shape when it comes to costs. But more importantly, we're riding an appreciating market and we will make more money, drive more margin and improve ROE by selling that house a bit later at a higher price. And that strategy has been in place now for a while. We're just a bit more obsessed about it and it's mandatory now that you have to hold the spec until that point.

Alan Ratner
Analyst, Zelman & Associates
Q

Understood. Thanks a lot.

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

Welcome. Thank you.

Operator: The next question comes from Deepa Raghavan with Wells Fargo. Please go head.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC
Q

Hey. Good morning, everyone. Great quarter.

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

Thank you, Deepa.

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Deepa Raghavan
Analyst, Wells Fargo Securities LLC
Q

Can you, Doug – hey, thanks. Doug, can you talk about your luxury strength versus active adult, you mentioned some of that, but also some of the trends you're witnessing there? Just talk about how your active adult category, for example, was pretty strong. How do you think that trends this year and next few years? And curious how that could benefit your margins or your balance sheet?

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

Sure. So when I break down the 85% order growth in Q2, affordable luxury was up 103%, luxury was up 48%. Age targeted/empty nester, the baby boomer crowd was up 135% and the smaller City Living operation was up 171%. So, affordable luxury will be the fastest-growing part of Toll Brothers as we focus more and more on the $400,000 to $650,000 price point for the 35-year old millennial. And you're going to see that grow fastest.

And as I mentioned earlier, the gross margin out of that business is now matching our traditional luxury business. So, we're very, very pleased with that. We knew it would have higher ROEs because the land is less expensive and we turn houses faster because they're smaller. We're just, obviously, delighted that the gross margin has been higher than we had thought.

So, going forward, we're not giving up on luxury. And as those millennials age more and more, they're going to be buying their second and third home. It's not that far away when we've got the 42-year old millennial, who is ready to move up. And that – we worked hard on this brand, and I hope you all join us next Wednesday, because I am sure, based on how hard we're working here, you are going to be blown away by some of the product, videos and photography and presentations by our management team and just how we do it.

And so affordable luxury will be the number-one grower. Obviously, age targeted/empty nester with that boomer crowd is doing better and better because they were on the sidelines for a long time through COVID.

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

It may be in the next quarter or two the strongest-performing segment...

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

Because of the....

[indiscernible] (00:56:18)

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

...because of the low base from a year ago.

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

Correct. Right. And I know we talk about it, but we do have the widest offering in the industry. You can buy a $300,000 house from Toll Brothers and you can buy a $5 million house. And that wide offering and the wider

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geography with all these new markets we've mentioned is what gives us such great confidence and excitement about the outsized growth that we can achieve.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Got it. Definitely looking forward to your Investor Day presentation. My follow-up question is on pricing mostly, a little bit two-part. What are your thoughts on keeping price when commodity starts to moderate? That's one part of it.

Second part of the pricing question is, right now you're capping your orders per community. When do you expect to be caught up? I'd appreciate if you have any thoughts on when you expect to be caught up. You know your lot positions. You know what you're taking right now, your intake. So, you should probably have an idea when you expect to be caught up.

So once you get to that equilibrium level, which enables you to lift caps, would pricing then still – will pricing start to get competitive? Would you start to think about probably lowering price, especially when that commodity starts to moderate? I mean, a couple points there, but appreciate any thoughts.

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

Sure. So, we have never based the price of our homes on the cost to build them. That's not the business model of Toll Brothers, and I don't believe it's a business model of many builders out there. We sell – we do detailed market comps on how much can we sell the home for, what will the market bear, what are the other new home communities by other builders selling for, what is the resale market selling for.

Our business – we will drive this price as high as the client will pay. If costs moderate and we still have the demand at the levels we have today, no, we're not stopping our strategy of allocation, we're not stopping our price increases or our sealed bid process. It is completely based upon market demand and market pricing.

With respect to when we get caught up, yeah, obviously, we're moderating sales right now, as we have discussed. The beauty is, at the moment, we control how much we sell. So, we have the levers in place to decide, hey, let's open five this weekend. Right now, it's all internal and we can make those decisions.

And as this backlog, up 57%, starts coming down a bit and we have a little bit less pressure on production where the next home sold can be delivered, not in 13 months or not in 12 months, but in 10 months, then you'll start seeing more and more of our communities open up, as I said, the way I'd like them to be where we can sell everybody a house. But the pricing decisions will not be based on anything, but the level of demand and the market comps.

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

And Deepa, our allocation decisions are community by community right now. And coming off allocation will be community by community as well, not overall company evaluation.

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

Right.

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Operator: And the last questioner today will be Truman Patterson with Wolfe Research. Please go ahead.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Hey. Good morning, guys, and thanks for taking my questions. I appreciate it. So, first, I feel like I might be beating this to death a little bit, but look – and clearly, lumber costs are a big topic of conversation. It sounds like you all have a lot of confidence in your gross margins going out to 2022. As of today, spot lumber costs, as of May, labor, et cetera, et cetera, you all have more than enough pricing in hand today to offset all of your costs at today's levels. And then, given all of these bidding processes that you all have been talking about, excluding mix shift to the affordable, what do you think core pricing was up in the quarter or year-over-year?

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

A

I think the best way that we look at the pricing versus cost equation, which is where I think you're going Truman is...

Truman Patterson
Analyst, Wolfe Research LLC

Q

Yeah.

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

A

...to overly simplify this, we have an $800,000 home we're selling. We have a 25% gross margin. And we have around 25% of the costs that are associated with the land and improvements. And so, those have been paid for previously. So, it's a two-for-one kind of equation. A 2% cost increase can be offset with a 1% price increase when you're looking at those cost increases from a labor and materials perspective.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay. Yeah, I got that. On the core pricing, quarter-over-quarter or year-over-year, do you all have that metric?

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

A

When you say price, is it cost or sales price?

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

A

Sales price, yeah.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Yeah, the sales price.

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

A

No.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay.

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

A

No, we don't.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay. All right. And on the affordable luxury, I know it's moved to 30% of your sales. Is this rolled out nationwide? Are there any new metros? Is there any additional expansion? And where do you think you could ultimately take that to? And Doug, you made a comment, I believe, in the prepared remarks about the streamlined construction process and possibly bringing these techniques to your other product segments. Could you just elaborate a little bit on that?

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

A

Sure. So, affordable luxury is now rolled out nationwide. That doesn't mean every single one of our 50 markets has it, but it is in place around the country. We have markets that are primarily all affordable luxury, Jacksonville, Boise as two obvious examples. We have other divisions that sell $2 million houses and they also have a significant affordable luxury business; example, Phoenix. And you'll continue to see new markets that may be lower priced.

One example, we're going to announce shortly that we're [ph] – kind of I'm (01:03:43) announcing today, that we're going to be reentering San Antonio. Well, San Antonio is primarily an affordable luxury market throughout, as Jacksonville is. But there's going to be other markets that we will enter that will be both luxury and affordable. And you will see more and more affordable luxury in the existing footprint.

With respect to cycle time, our cycle time came down again from the first quarter to the second quarter by about 10 days. That was a combination of our operations teams clicking, and we have restructured how we operate in the field, and more affordable luxury, where by its nature we turn those houses faster.

So, the things we are learning on the affordable luxury side, Marty talked a bit about optimizing our plans, and we're going to talk more about this next Wednesday, we're not changing the buyer experience. We're not pulling the opportunity of choice, the opportunity to upgrade your home out. We're just optimizing the plans. We're making them more efficient. We're making them better.

Better can also be less expensive, better can also mean you can build faster. And that's what optimization's all about. So even though we're hot and we're busy, we are actually building houses faster than we ever have. And it's a combination of all those things I just mentioned.

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Truman Patterson
Analyst, Wolfe Research LLC

Q

Perfect. Thank you, guys, for the time and good luck in the upcoming quarter.

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

A

Thank you, Truman.

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

A

Thanks, Truman.

Operator: Just a reminder, the market is opening, so this concludes our question-and-answer session. I would like to turn the conference back over to Doug Yearley for any closing remarks.

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

Drew, I thank you. Thanks, everyone, for your interest and support. I'm sorry that we didn't get to every question, but next Wednesday there will be plenty of opportunity during our three-hour Analyst and Investor Day for Q&A. We have built Q&A in throughout the day. And I'm really, as I said, excited to share next Wednesday with all of you, so proud of this company and just so proud of what we're going to be able to show you next week about how we operate and, most importantly, the people within this company that do all the work.

So, hope you can join us. And thanks again. Have a great balance of the week and weekend, and we'll see you next week. Thanks.

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

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