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Toll Brothers, Inc. (TOL)

Q3 2021 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Toll Brothers Third 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] Please note this event is being recorded. The company is planning to end the call at 9:30 when the market opens.

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

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

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 performance in the third quarter. Demand continues to be very strong. We are benefiting from our strategy of expanding our product lines, price points, and geographies, as we continue to grow the business, drive price, expand margins, and improve our capital efficiency.

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Home sales revenues of $2.23 billion were up 37% compared to the prior-year period. Adjusted gross margin of 25.6% was up 170 basis points compared to last year. Both our pre-tax income of $303.4 million and on our EPS of $1.87 more than doubled compared to last year.

We signed 3,154 net contracts for approximately $2.98 billion, up 11% in units and 35% in dollars compared to the prior-year period. These were third quarter records in both units and dollars. In addition, our contracts per community at 10.2 were 20% above last year and our highest third quarter ever.

Our average selling price in the quarter was approximately $945,000, up $70,000 compared to the second quarter and up $163,000 year-over-year. This increase in ASP shows the pricing power of our luxury business. This strong demand has continued into our fourth quarter. We've averaged over 300 non-binding deposits per week in the first three weeks of August, a pace that is consistent with May through July.

Not surprisingly, our deposits were down 15% compared to the same three weeks last August when demand surged following the lifting of COVID lockdowns. However, compared to the same three weeks of August 2019, deposits were up 29%. In some markets, demand still far outpaces supply and we are limiting lot releases. In other markets, we are seeing demand return to seasonal patterns.

I want to remind you that in the summer or fall of 2020, we along with the rest of the industry experienced a historic surge in demand and sales. From August 1 to September 15, 2020, the first half of our fiscal 2020 fourth quarter, net signed contracts were up 110% in units; and for the full quarter, they were up 68%. We knew these growth rates would be unsustainable. And as a result, we expect our fourth quarter contracts to be down compared to last year. While year-over-year order declines may make headlines, they don't reflect the current state of this housing market, which remains very strong.

In the near term, our biggest challenge is managing industry-wide supply and labor constraints that are extending delivery times. In our third quarter, cycle times grew by about two weeks, pushing some anticipated third quarter deliveries into our fourth quarter. This same pressure will apply to our fourth quarter.

During the third quarter and into the start of our fourth quarter, we raised prices in most of our communities. Just this past Monday, we rolled out another nationwide price increase. These increases have more than offset cost pressures we've experienced this year.

In light of the pricing embedded in our backlog and our focus on managing costs, we are confident that our gross margin in fiscal 2022 will significantly exceed the 25.6% margin we project for fiscal 2021's fourth quarter. It is important to note that our customers are generally better positioned to absorb price increases due to their higher incomes, investment portfolios, and the benefit of increased values in their existing homes.

In terms of demand across our markets, strength in the quarter was broad-based across both geography and product type, with especially strong demand in our affordable luxury and active adult communities. With our strategic expansion in the Sunbelt and Mountain States, we continue to benefit from migration out of higher cost markets into more affordable markets, lessening the impact of affordability as prices have risen.

Our backlog at quarter end was a record in both units and dollars. Backlog was $9.4 billion on 10,661 units, up 55% in dollars and 40% in units compared to last year. As we noted last quarter, we expect meaningful growth in revenue, gross margins, earnings and ROE in fiscal year 2022. We reaffirmed these expectations, including a return on beginning equity for fiscal 2022 well above 20%.

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These expectations are driven not just by the strength of the housing market and our backlog, but also by the structural and permanent changes we have made to many aspects of our business, especially to how we acquire and develop land in a more capital-efficient manner. We remain bullish on the long-term prospects for the housing market, which is supported by many factors, including the significant imbalance between the supply and demand of homes.

On the supply side, this imbalance is the result of a decade of underproduction of new homes. On the demand side, millennials who make up the largest generation of Americans are forming families and entering their prime home-buying years. We've also seen baby boomers and other active adults reenter the market. Many older workers are accelerating their plans, moving now and working virtually in places they might have planned to move to a few years later.

Interest rates remain low. The resale market is tight. Americans have a much greater appreciation of home and the overall economy is improving. We believe that all these factors will continue to contribute to strong and sustained demand for new homes in the years to come. And we are well positioned to capitalize on the opportunities this market presents.

At quarter end, we owned or optioned approximately 79,500 lots. Our option lots represented 53% of our total lots controlled at third quarter end compared to 49% one quarter earlier and 43% one year ago. We have already made significant progress in moving towards the 60% optioned and 40% owned goal we set last quarter.

This shift to more option land is a key part of our capital efficiency initiatives. This land position provides the foundation for growth over the next several years and we are currently benefiting from the significant percentage of our land that we acquired at lower pre-pandemic prices.

At quarter end, we were selling from 314 active communities. We continue to project growth to 340 communities at fiscal year end and an additional 10% community count growth in fiscal 2022. This guidance is based solely on land we already control today.

We also have the land under control today for meaningful further community count growth in fiscal year 2023. Our strategic expansion into new markets, new product lines, new price points and especially the affordable luxury niche has positioned us well for growth and is contributing to improvements in both our gross margin and our ROE.

In fact, our affordable luxury homes are generating gross margins that are comparable to our luxury homes. Affordable luxury comprised 44% of deliveries in the quarter ended July 31, up from 40% last year. First-time home buyers, who are the primary buyers in our affordable luxury segment, accounted for 29% of our deliveries this quarter compared to 27% one year ago.

Our affordable luxury product enables us to move into new markets and expand our presence in markets where we are already established. These homes appeal to many millennials, who are making their first home purchase, and can be built more quickly and efficiently and on less expensive land.

Just last week, we announced the acquisition of StoryBook Homes in Las Vegas. With about 550 owned and controlled lots, this acquisition allows us to quickly expand our affordable luxury offerings in the Las Vegas market. StoryBook is a remarkably efficient builder and we look forward to sharing lessons learned from its operations throughout the rest of our organization.

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We continue to focus on additional ways to improve capital efficiency to bolster ROE. Yesterday, we announced a new strategic partnership with Equity Residential, a world class S&P 500 company, focused on luxury apartment rentals, to jointly acquire and develop sites into new rental apartment communities in key US markets of Metro Boston, Atlanta, Austin, Denver, Orange County, Seattle and Dallas.

Over the next three years, we expect Equity Residential to invest 75% of the equity for each selected project with our Apartment Living unit investing the remaining 25%. We expect each project to be financed with approximately 60% leverage. We are targeting an initial minimum co-investment of approximately $750 million in combined equity between the companies, or nearly $1.9 billion in total capacity, assuming the 60% leverage.

We will act as managing member of each project, overseeing approvals, design and construction and will receive development, construction management and financing fees, as well as a promoted interest upon the sale of each property. Equity Residential will receive fees for property management, leasing and marketing services, as well as construction oversight.

We've identified three land parcels that we already own to jumpstart the venture. The total anticipated cost of these three projects is approximately $242 million. The venture should allow us to develop more apartments with less capital, improving the capital efficiency of the Apartment Living business. We also expect this venture to produce a more predictable stream of earnings from our Apartment Living business, as we expect to sell each developed property at stabilization, in most cases to EQR.

We are very excited about this partnership with EQR and we hope we can expand on this relationship. We are also looking to forming one or more additional programmatic relationships in markets and for products that are not covered by our agreement with EQR. We expect that such a partnership would provide a similar capital-efficient platform for the balance of the Apartment Living business.

Now, I'll turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug, and good morning, everyone. Thanks for joining us. Operationally, we had another great quarter. Our production teams continued their solid performance as we manage through the labor and supply chain issues that have impacted home-builders this year. We thank them for their efforts and accomplishments.

We delivered 2,597 homes at an average price of approximately $860,000, generating third quarter home-building revenue of $2.23 billion. Deliveries were up 28% units and 37% in dollars compared to one year ago. We met our revenue projections due to a higher average price of deliveries than anticipated.

Our third quarter pre-tax income was $303.4 million compared to $151.9 million in the third quarter of 2020. Net income was $234.9 million or $1.87 per share diluted compared to $114.8 million and $0.90 per share diluted one year ago.

Third quarter adjusted gross margin was 25.6% of revenues compared to 23.9% in fiscal year 2020's third quarter, and 80 basis points better than projected. The outperformance was due primarily to improved pricing power and favorable mix.

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SG&A as a percentage of home sales revenue in the quarter was 10.5% or 110 basis points better than our guidance. We attribute this primarily to lower-than-expected selling and marketing expenses as well as continuing and permanent overhead cost controls.

Joint venture, land sales and other income was $29 million in the third quarter compared to $3.6 million in the same quarter last year. Our projection was approximately $20 million. The outperformance was driven by better-than-expected results from our mortgage operations and our Apartment Living operations.

Our balance sheet remains strong. We ended our third quarter with approximately $2.7 billion of liquidity, including $946 million of cash and approximately $1.8 billion available under our $1.9 billion revolving bank credit facility. In the third quarter, we invested approximately $200 million in land acquisition and another $230 million in land development.

Due primarily to our focus on acquiring land more efficiently, our land and development spend is projected to be slightly lower in fiscal 2021 than what we spent two years ago in fiscal 2019 despite our significant growth since then. These structural changes in how we acquire land are also permanent and are contributing to our significant increase in return on equity in 2022 and beyond.

We expect to generate $750 million in cash from operating activities in fiscal year 2021. We will continue to use our cash to invest in the growth of our business, return cash to shareholders and further reduce our debt, including retiring $410 million of our 5.875% public notes that are due in February 2022.

We intend to call these bonds in our fourth quarter and retire them at par in mid-November 2021. Our net debt to capital ratio stands at 33.1% at third quarter end, and we expect it to drop to the mid- to upper-20% range at fiscal year end.

During the quarter, we continued our program of returning the capital to shareholders through share repurchases and dividends. In our third quarter, we repurchased approximately 1.7 million shares at an average price of $57.66 for an aggregate amount of $95.4 million. We expect to repurchase a similar amount in our fiscal fourth quarter.

In April, we increased our quarterly dividend by 55% to $0.17 per share. These actions reflect our confidence in our business and in the sustainability of our substantial cash flows moving forward.

Turning to fourth quarter and full year guidance, due to the production delays impacting our industry, we now expect full year deliveries of approximately 10,100 homes compared to the midpoint of our previous guide of 10,300 homes. These 200 deliveries, which are sold and have substantial deposits from our buyers, are now projected to settle in the first quarter of fiscal 2022.

So, we now project our fourth quarter deliveries to be approximately 3,450 homes. We estimate an average delivered price for the fourth quarter of approximately $840,000 per home and approximately $830,000 for the full year. This is an increase of $15,000 per home compared to our previous fiscal year guidance.

We are projecting a fourth quarter adjusted gross margin of 25.6% of revenues and a full fiscal year 2021 adjusted gross margin of 24.9%. This is an increase of 30 basis points compared to our previous full year guidance.

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Based on the composition of our backlog, we are confident that our full year fiscal 2022 adjusted gross margin will significantly exceed the 25.6% margin we are projecting for the fourth quarter of fiscal 2021. Our confidence is based on several factors, the most significant of which is the higher prices that are embedded in our backlog, which is the result of the steady and significant price increases we've achieved over the year. Demand is allowing us to continue to push price in most of our markets.

In addition, we are intensely focused on our construction budgets and managing building costs. Like the entire industry, we are seeing cost pressures on material and labor. We enjoy stronger relationships with our trade partners and have tremendous operating scale, which helps us to manage these costs. We also continue to benefit from our long land position. The land for most of the communities that will be delivering homes in fiscal 2022 was put under control prior to the pandemic at lower prices.

Turning back to guidance, we expect interest and cost of sales to be approximately 2.3% of home sales revenues for the fourth quarter and full year. This full year guidance is 20 basis points better year-over-year and reflects the impact of debt reductions made earlier this year.

We expect our interest expense to continue to decline in fiscal 2022 as we further reduce our leverage. We expect SG&A as a percentage of revenue to be approximately 9.8% in the fourth quarter and 11.3% for the full year. This full year guidance is 50 basis points better than previously projected. As Doug mentioned, we expect community count to be 340 at fiscal year end with 10% growth from there by fiscal year 2022.

Our full year guidance for fiscal year 2021 other income, income from unconsolidated entities and land sales is now $140 million for the full year, with approximately $40 million projected for the fourth quarter. This is a $30 million increase from our projection last quarter and is driven by more sales projected in our Apartment Living division.

Our third quarter tax rate was 22.6%, which includes approximately $12 million in energy tax credits. Our fourth quarter effective tax rate is projected to be approximately 26% and our full year guidance is 24.6%, 90 basis points better than our previous fiscal full year guidance.

Taking this all into account, we have increased our projected return on beginning equity for fiscal year 2021 to 15.9%, over 700 basis points better than fiscal 2020. As Doug noted, we expect it to exceed 20% in fiscal year 2022. And we believe our capital efficiency initiatives and the structural changes in our land acquisition strategy will keep it above 20% long term.

Now, let me turn the call back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. I would like to take this opportunity to extend my sincere thanks to the tremendous effort from all of our Toll Brothers team members. They continue to demonstrate their dedication to taking care of each other and our customers; and for that, I am very grateful.

Now, let me open it up to questions. Andrea, ready to go.

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QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. [Operator Instructions] As a reminder, the company is planning to end the call at 9:30 when the market opens. [Operator Instructions] And the first question comes from Deepa Raghavan of Wells Fargo. Please go ahead.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning, (sic) Doug, Marty. Thanks for taking my questions. (sic) Doug, based on your comments on the 20%-plus ROE growth target, the emphasis on the plus appears to be slightly stronger than what we heard on your prior call. Is that a fair observation?

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

A

Yes. And we will, obviously, give more detailed guidance on our fourth quarter call in three months. But yes, you picked that up correctly.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Q

And I'm assuming that's driven by the gross margin predominantly, or is there anything else driving that?

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

A

It is driven by prominently the gross margin, also the increase in sales, and our land-buying strategies that we've been talking about for the last couple years that will continue to push that ROE up permanently.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Q

All right. My follow-up question is on more recent trends. Are there any trends in July and August that maybe stood out for you or worth calling out? I'm particularly looking for trends and nuances that the other June quarter-ending peers haven't pointed to so far.

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

A

Yeah, the sales and the demand throughout the third quarter were pretty consistent month to month. As I mentioned in my prepared comments, in many markets, we still see demand that exceeds supply, exceeds our ability to deliver. And in those markets, in those communities, we're either still on allocation. We're more aggressively driving price. We're running processes that include best and final offer to interested and prequalified buyers. And so, that really hasn't changed.

I think the one thing we have noticed in some markets, and they are primarily markets that I would describe in the Northeast and the Midwest, now the Midwest for us is really just Detroit, because we're down to one community in Chicago, where we're seeing some more of the typical summer seasonal trends. Traffic is up. Web traffic is up. We continue to raise prices. As we mentioned, this past Monday, we had a price increase nationwide.

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So, I don't think there is anything significantly different in July and August, except that in some markets, primarily those I mentioned in the Northeast, we're feeling some more seasonal trends and we expected that. As the world opened up, as people hit the Jersey Shore or did whatever they normally do in their summer months, and now they're preparing to get their kids back to school, we're seeing in those markets more traditional seasonal trends.

But that doesn't mean a slowing, and that's why I caution with the year-over-year comp, it's still a very good market. There's just some of those seasonal trends occurring out West, and for us, of course, we call that Denver West; Down South, and for that, I'd say, the Carolinas, Georgia, for us, is Atlanta, South Carolina and Florida, we are still seeing most of those markets with more demand than we can satisfy.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Q

That's great color. Thanks very much. Great quarter. Thanks.

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

A

Thank you.

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

Bryan Adams
Analyst, Evercore ISI

Q

Hey, guys. This is actually Bryan Adams on for Stephen Kim. Thanks for taking my questions here. I wanted to talk about the 4Q pricing guide a little bit quickly. You saw really strong price on your deliveries this quarter, I think sequentially up 6% or so. And given your comments, it sounds like what you're seeing on the ground is still very strong pricing. If I look at a typical 4Q, where you often have some – you actually have some of your highest ASPs. So, the sequential decline that you're guiding for into next quarter, is there anything unusual maybe from a mix perspective that can explain that dip?

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

A

Yeah. I think the biggest aspect is our City Living business. It represented about 8% of our third quarter deliveries. We expect it to represent 3% of our fourth quarter deliveries and be less than that in 2022. So, that is a higher margin, higher average price business. And that is influencing both the margin progression as well as the average price that we reflect in the fourth quarter.

Bryan Adams
Analyst, Evercore ISI

Q

Interesting. Hey, Marty...

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

A

We'll have a little bit more Pacific in Q4 as well.

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

A

Yeah, I think, right. Well, Marty just finished there and he got cut off a little bit, there is going to be a little bit more coming out of the Pacific in the fourth quarter, which is also higher priced, higher margin, so that will have some offsetting effect on a bit less of the City Living. But then as we look forward to 2022, I think you really need to pay attention to the sales prices that we – $945,000 sales price that you saw in the third quarter, because that is really nationwide, we've had pricing ability everywhere and that's what's going to be driving the higher price in 2022.

Bryan Adams
Analyst, Evercore ISI

Q

Great. I have one follow-up on margins actually, and specifically wanted to talk about costs. And maybe some of this dovetails with what you just said, but you're implying margins are going to be flat in 4Q. Does that assume higher lumber costs in 4Q than in 3Q? And I also just wanted to get a sense of, if we think about the peak – like, peak lumber being this past spring coming to a head in May, when you're expecting that to make its way into your reported results? Thanks, guys.

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

A

Yeah. So, the lumber costs for the homes we are building will peak through Q4 2021 and Q1 2022. And then, starting in Q2 and accelerating through the balance of 2022, we will see what is a significant drop in lumber. Right now, with the size of our homes and the amount of lumber we put in them, our average house is down, in the future, again, the homes sold today, when they need lumber, will be down as much as $40,000 in lumber, which will have a nice benefit in the back half of 2022.

Bryan Adams
Analyst, Evercore ISI

Q

Awesome. Thanks, guys. Great quarter.

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

A

Thank you very much.

Operator: The next question comes from Buck Horne of Raymond James & Associates. Please go ahead.

Buck Horne
Analyst, Raymond James & Associates, Inc.

Q

Hey. Thanks. Good morning. I just wonder if you could follow up a little bit more on the Equity Residential deal. Just, number one, very capital efficient, so great use of resources, but how do you determine the pricing on those assets at stabilization? I'm just curious, is there some sort of implied cap rate you go into – predetermined to construction with Equity Residential or is it kind of a right of first offer, but they don't have the obligation to buy? How does that work?

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

A

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Sure, Buck. And great shout out to Charlie Watts last night. That was cool. I'm the old guy in the room. I'm not going to tell you how many times I've seen the Rolling Stones starting in high school, but that was a cute shout out. We're really excited about the EQR deal. It's just so nice to be aligned and in partnership with the leading luxury apartment owner, manager in the country. Such a fantastic company that we have a track record with. We built a very large complicated high-rise with EQR 10 or 15 years ago in New York City. Bottom half is rental, top half was luxury condos that we sold. And so, we really – it's such a pleasure to have a relationship with a company that talks our talk, walks our walk, gets the business. They're going to help us because they have so much intelligence in so many of these markets we're operating with them.

The key to us was driving capital efficiency through the apartment business. They will now come in and help us cover predevelopment costs before we buy the land. They will invest at land closing with us. And then, we are committed to sell all of the assets at stabilization. We're not going to hold apartments long term anymore. We understand the need to recycle the investment, to show investors regular, predictable, sustainable earnings, and how we – to your specific question, after my sales pitch here, how we come up with an exit price, it's a very thoughtful, pragmatic approach that allows EQR, without a complicated marketing process, but with the appraisers involved, to buy us out. Now, remember, they have 75% of the investment. They only have to buy out the 25% of Toll.

So, they're going to get the benefit with their 75% investment of any uptick in value. If we're unable to agree or if, for some reason, they don't want the asset, then we're going to sell it. We're not going to hold it. We're still going to sell it. So, we're going to get our money back at stabilization. But they have to pay fair value. They know they're not going to be taking advantage of us by getting a price that's under market. But we also understand that we're saving marketing dollars with brokers and running a process and the delay that's involved in running those processes and a due diligence process with a third-party that you're not sure how it works out in the end. And so, that's the basic parameters around how it works. Marty, anything you want to add to that?

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

I think they can bring some operating efficiencies to the projects through their property management that will enhance the value. They have a relatively inexpensive cost of capital, so we know we're selling to a efficient capital source. And as Doug mentioned, they're really only buying a quarter of the asset at fair value, they have the other three-quarters of it at cost.

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

Right. And so, this is a win-win. EQR, they wanted a strong development partner to feed them new opportunities. And we wanted a capital-efficient platform and we've gotten it through the best in the industry. Now, there are markets not covered. There are some properties that won't be covered, for example, our Student Housing business is not something that EQR, at the moment, is interested in.

They can't take the advantage of Opportunity Zone assets the way others may be able to. And so, we are actively talking to the other private equity players that we have built this business with to find one or more structural permanent long-term partners to complete the business model, very similar to what we've done with EQR on their markets.

Buck Horne
Analyst, Raymond James & Associates, Inc.
Q

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That is a great color. Thank you so much. That's really fantastic deal. I really like the platform there. So, congrats on that.

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

A

Thank you.

Buck Horne
Analyst, Raymond James & Associates, Inc.

Q

Second, I guess I'll follow up in a different direction. There is some new legislation that seems to be percolating through Washington, I guess Senator Wyden's got a new housing bill or proposal as part of the new infrastructure plan that includes things like a $15,000 first-time buyer tax credit, also looks like a developer tax credit to kind of stimulate new home-building supply in lower income market areas or maybe more outlying areas.

I'm just wondering if you guys have had any time to look at those proposals or have any general thoughts or impressions about how a first-time buyer tax credit could impact a market like it is today or any other thoughts on that potential legislation.

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

A

Yeah. We haven't had a lot of time to study it. Anything that Washington does to promote, stimulate homeownership, even if it's a bit below our typical price point, is good for the industry, it's good for Toll Brothers. We're, as you know, coming down in price to affordable luxury. There have been tax credits in the past that have been effective in stimulating demand. There is a significant housing shortage in this country. And in certain states, the obvious one is California, there is an affordability issue that has to be addressed.

So, we and the industry would be fully supportive of Washington's continued focus on this housing crisis, on promoting homeownership. And so, as this develops, and of course, we don't know where it's going to go, it's impossible to predict right now. We, as Toll Brothers and, of course, as an industry, and working through our lobbying group, Leading Builders of America, will be all over it and I'm sure will be supportive.

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

A

Yeah. And as we mentioned in the prepared remarks, nearly 30% of our buyers right now are first-time homebuyers, at least one person on the deed. We need to see what the specifics of the legislation might entail, whether it's one or both and whether there is income limits there. We are active in our apartment business in Opportunity Zone, so we do serve some areas that may be enveloped by some of these other provisions. And in many situations, we have affordable housing components of some of the developments we do. So, we'll have to study whether that's beneficial to us or not.

Buck Horne
Analyst, Raymond James & Associates, Inc.

Q

Great. Thanks for the color, guys. Great quarter.

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

A

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You're welcome. Thank you, Buck.

Operator: The next question comes from Mike Dahl of RBC Capital Markets. Please go ahead.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Good morning. Thanks for taking my questions. The EQR deal is really interesting. I want to start with a question on that. I guess, a two-part question. You've got the 25% interest, but you also have these fee structures in place, plus the promote on sale. Should we think of it as, on an ultimate sale, that your return on investment is greater than that 25% given the fee structures that are in place? Or any other color there on quantifying that.

And then, the second part is just on the initial three assets, just how to think about that and whether that's embedded in terms of some of the other income guide for 4Q?

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

A

So, on your first question, yes, we expect to receive more than 25% of the sale proceeds. Even for getting fees, that's how a promote works. And we have that now with our existing, more fragmented business model where we have multiple private equity partners, but now this all consolidates it and will just make it a lot more efficient. Marty, why don't you talk about the three assets?

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

A

So, the three assets, we already own that land, we have not commenced any construction. They are relatively inexpensive pieces of land, but it will be part of our initiative to reduce the capital that we have in Apartment Living. Our Apartment Living investment has gone down from $770 million at the beginning of the year to $650 million right now. It will drop a little bit further as a result of that.

Those three assets still need to be developed. They need to be leased up. And so, that's a 2023-2024 sort of income event. But we did sell an asset in our third quarter to Equity Residential and we've already sold an asset in our fourth quarter to them that weren't developed under this program, but were marketed in the general marketplace, if you will. And that fourth quarter gain is embedded in our $40 million guidance for the fourth quarter.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Okay. That's very helpful. And then, my second question is really on the returns and capital efficiency, because clearly you're trying to do your best to articulate this to the investment community. It seems like it's potentially one of the more underappreciated areas and, obviously, margins in the near-term sales, to your point, Doug, those contribute to the return on equity next year. But it looks like you're at the point where all of the actions on capital efficiency are hitting an inflection point in 2022 or more of an inflection point in 2022.

So, I guess, the question is, are there certain quantitative targets that you're going to be setting out, not just saying the returns are in excess of 20%, but something like asset turns, for example, where that's been kind of the main area that you may have not performed as well as some peers that looks at the change? How are you thinking about that or how should we be thinking about potential for improvement in asset turns over the next year or two?

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

A

Yeah. So, on the call in three months, we will give a lot more detail on 2022 in terms of margin, in terms of ROE. But you're right, 2022's ROE right now is partially due to the new land-buying and other efficiency strategies that we started a couple of years ago, but it's primarily being driven by this beautiful wave we're all on of driving price, having high sales numbers and having high gross margins.

But beyond that, the reason we're so confident in sustainability of the higher ROE that will be north of 20% long term is because of the land we've been buying. We are so disciplined now on, internally we call it IRR, but that translates easily to a macro ROE for the company, each land deal has to pass such a higher hurdle that as that comes through and delivers into 2023 and beyond, it's just a new company, it's a new business, and it's structurally changed. And if the market doesn't get it, that's not for us – for a lack of us trying to explain it, I think we understand that we have to prove it out. And I'm very confident it's coming.

We have so many different ways we can buy land now and continue to grow this company, whether it be through land banking, or through joint ventures, or if you purchase money mortgages with land sellers or getting longer-term payment terms with land sellers. And that is all working its way through the new communities that will be opening and that will be delivering homes.

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

A

Yeah. I think you see a bunch of these initiatives already reflected in our balance sheet, where our owned land is down to 47%, when it was 75%, 80% five years ago of total. We've made great progress on that recently, seen a little bit of these initiatives in our JV and other line that's grown a little bit as we put some of our larger communities into joint venture. You see it in our cash flow that's being generated. Significant cash flow this year, last year and projected for next year that allows us the flexibility to buy stock back, pay down some debt, increase our dividend. All of those things are driven by some of the ROE initiatives. It's not just how we do things. It's how we inherently think about things now too that's influenced with our ROE mentality.

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

A

Right.

Mike Dahl
Analyst, RBC Capital Markets LLC

Q

Yeah. It's great to see it coming through or starting to come through. Thanks for taking my questions.

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

A

You're very welcome. Thank you.

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

Alan Ratner
Analyst, Zelman & Associates

Q

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

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

A

Hey, Alan.

Alan Ratner
Analyst, Zelman & Associates

Q

I appreciate all the color so far. So, I'd love to ask maybe an additional question on the ROE topic. Obviously, the asset efficiency is huge and we could see that filtering through over the next couple of years. I guess, my question is, when you think about the sustainability of those options and land banking availability, we've seen over time that tends to be somewhat cyclical. I mean, your option share got as high as 60% in the last cycle, too, and generally, that capital tends to dry up a little bit if the market moves sideways or we enter a recession. So, I guess beyond 2022, the confidence there, do you think it's different this time in that there is longer-term capital being attracted to the space that will kind of stick with it through a potential downturn in the future? And I'll stop there, and I have a follow-up. Thanks.

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

A

Alan, I think some of the growth in owned land from the last cycle was a function of the ability to walk from options and the risk profile the option concentration gives you. So, it wasn't necessarily driven as much by a lack of capital sources, although I'll admit that it was a function of choosing not to move forward with those deals, which is a positive side benefit of the return on equity initiatives here in circumstances that aren't as great as they are today.

So, I think there are much more significant piles of capital interested in this business as all of us builders have fundamentally changed the way we look at our business to be more return on equity focused and are providing solid returns to these capital-efficient structure supporters, while also improving our own capital efficiency.

Alan Ratner
Analyst, Zelman & Associates

Q

Got it. I appreciate that, Marty. Maybe we can follow-up a little bit more on that offline. But maybe moving back to the fundamentals for a second, Doug, on the nationwide price increase on Monday, can you talk a little bit about the magnitude of that increase and kind of what the trend has been there lately? Have you been kind of maintaining the same pace of price increases? Have they moderated a little bit? And what's the thinking going forward? I know few builders have said they're not expecting to see the same type of pricing power going forward. It doesn't sound like that you guys see it the same way.

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

A

Monday's price increase was not all that big. It was 1%. It's an opportunity to get sales excited, get them to make some phone calls and say, hey, you got to get in this weekend because the boss tells me Monday I'm going to have a new price sheet in my hand. And so, we use these price increases locally and, on occasion, with the nationwide program like Monday to drive urgency, and it's very effective. So, to me, what happened Monday is less about the 1%, I'll take it, I like it. But it's really about putting another tool in the toolbox of the sales team to go make a phone call and create that urgency.

I'm not going to disagree with some of the other builders. And it goes back to my earlier comments that in some markets, we're seeing more traditional seasonal patterns of sales activity. So, in those markets that I described, out West and down South, where we still have demand far exceeding our ability to supply, we're raising prices as

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we were through last winter and spring. And in other markets, where we have seen good, but what I'll say is not great or not frothy demand that we saw last year, we're being more careful. I think that's the best way that I can describe it to you, Alan.

Alan Ratner
Analyst, Zelman & Associates

Q

Got it. No, that makes sense. I appreciate it. Thanks a lot.

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

A

And also just as a – we do these national sales events, which again it's another tool in the toolbox to get salespeople to make phone calls and say, hey, for the next three weeks, you got to come in, we're having a national sales event. It's usually a modest – maybe the cabinet company has agreed to give us a second or third upgrade to the kitchen cabinets, that doesn't cost us anything, but get some action cooking. We did not have a national sales event in the third quarter. We did have one in the third quarter of 2020, but we decided to take a quarter off. So, we were encouraged – further encouraged by the sale activity of Q3 without having that national sales event occur.

Operator: The next question comes from Susan Maklari of Goldman Sachs. Please go ahead.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good morning, everyone.

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

A

Good morning, Susan.

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, can you talk a little bit about the StoryBook deal? What is the M&A pipeline looking like today? How are you thinking about the ability to get future deals done? And maybe kind of what brought StoryBook to you and what helped you to get over the finish line with that?

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

A

Sure. StoryBook is a small, lower-priced home-builder in Las Vegas, incredibly efficient, remarkably high margins for the price point of their homes. We started conversations with them pre-COVID. We then put those conversations on hold in the spring and summer of 2020 when we were all pretty scared by COVID. And we were able to keep the relationship moving and get the deal closed a few weeks ago.

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Five years ago, we wouldn't have looked at StoryBook, because we wouldn't have gone down in price that way. Now, as we're doing more and more affordable luxury, as we have acquired a couple of different affordable luxury price point builders, Sabal Homes an example in South Carolina, Coleman Homes an example in Boise, we're learning from these builders that are superefficient in their field construction methodologies. And so, while a small deal, it's a good deal for us, not just for Vegas, but we think to continue to teach us to be better lower-priced home-builders.

In terms of deal flow, things are heating up quickly on the M&A front, just with the smaller builders. I'm not talking big to big, or big to mid. I'm talking, it just seems like there are more and more opportunities in markets throughout the country for the small local builder who has decided to take their terrific 2021 numbers and hire a broker and hit the market. And so, nothing to talk about, but we're active. Our M&A group is seeing more deal flow than they've seen in a long time.

Susan Maklari Q
Analyst, Goldman Sachs & Co. LLC

Okay. That's great color. My follow-up question is on the SG&A. That obviously came in over 100 basis points lower than what we were expecting for this quarter. You guided it down a little bit more for the fourth quarter. Can you talk to what really drove those actions that you've been putting in place in terms of reducing the overhead to come through this quarter and the sustainability of that, especially as we look to fiscal 2022?

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

I think a lot of the initiatives there, Susan, are associated with a bit less marketing spend, better control on our model home costs, some reduction in commission expense that we are seeing. And then, from a true overhead perspective, we're very tight on cost controls around the organization and here at corporate, and we think most of those things will be permanent. Our employee count dropped pretty significantly a year ago and we are keeping a tight rein on any additions to the employee count. The teams are doing great jobs with fewer people.

Susan Maklari Q
Analyst, Goldman Sachs & Co. LLC

Okay. Good. All right. Good luck with everything.

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

Thanks, Susan.

Operator: 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.

Thanks, Andrea. Thanks, everyone, for listening in, for your interest. Hope you have a safe and healthy and happy few final weeks of summer. And we look forward to speaking with you over the next few months and, of course, giving you more detailed updates on 2022 in December. Be well. Thanks.

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

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