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Toll Brothers, Inc. (TOL)

Q4 2021 Earnings Call

CORPORATE PARTICIPANTS

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

OTHER PARTICIPANTS

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Truman Patterson

Analyst, Wolfe Research LLC

Stephen S. Kim

Analyst, Evercore ISI

Mike Dahl

Analyst, RBC Capital Markets LLC

Alan Ratner

Analyst, Zelman & Associates

Michael Rehaut

Analyst, JPMorgan Securities LLC

Rafe Jadrosich

Analyst, BofA Securities

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Toll Brothers Fourth 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 also 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, Tom. Good morning. 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, interest rates, the impact of the pandemic, the availability of labor and materials, inflation and many other factors beyond our control that could significantly affect future results. I'm incredibly proud of our company's performance this year as we executed on our strategic goals of driving growth, increasing profitability and improving capital efficiency.

In fiscal 2021, we delivered nearly 10,000 homes, the most in our history and we grew homebuilding revenue by 20% to a record \$8.4 billion. We continue to expand our margins. Our full fiscal year 2021 adjusted gross margin

was 25%, a 150 basis point improvement over fiscal 2020, and we reduced our SG&A expense as a percentage of revenue by 160 basis points year-over-year to 10.9%. We nearly doubled our pre-tax income to \$1.1 billion, achieved our highest net income ever of \$833.6 million and we grew earnings per share from \$3.40 last year to \$6.63 in fiscal 2021.

And we delivered on our strategy of improving returns, with an increase in return on beginning equity of 830 basis points to 17.1% for the full year. These results reflect the strength of the housing market, the benefits we're realizing from our strategic expansion into new product lines, price points and geographies and our focus on driving operating efficiencies and improving the capital efficiency of our land acquisition strategy. At fourth quarter end, optioned lots represented 55% of our total lots, up from 43% one year ago.

And while we're pleased with our performance in fiscal 2021, we expect even better results in 2022. At fiscal year-end our backlog stood at a record \$9.5 billion and 10,302 homes. It is supported by substantial, nonrefundable deposits and our cancellation rate as a percentage of beginning quarter backlog was a very low 1.3% in the fourth quarter. Based on this solid backlog, we expect to grow homebuilding revenues by an additional 20% in fiscal year 2022.

We also expect to increase our full-year adjusted gross margin by 250 basis points due primarily to the strong pricing in our backlog which reflects the significant price increases that we've implemented over the past year plus the operating efficiencies that we continue to gain through optimized floor plans, curated options in our design studios and streamlined operations.

And we project a return on beginning equity well above 20% in fiscal year 2022, driven by our permanent pivot to a more capital efficient land strategy and our improved profitability. In the fourth quarter, demand for our homes remained very strong. We signed 2,957 net contracts for approximately \$3 billion, up 18% in dollars due to a 26% increase in the average selling price of our homes year-over-year.

As we start fiscal 2022, demand continues to be very healthy. We have averaged over 300 non-binding reservation deposits per week in the first five weeks of our fiscal first quarter, the same pace we have run at for many months now. On a per community basis, this pace is also consistent with the pace that we saw over the comparable five-week period last year. We're very encouraged by this considering how strong the first quarter of fiscal 2021 was.

Demand strength is broad-based across both geographies and product types. We're benefiting from the wide variety of homes and price points that we now offer in more than 60 markets in 24 states. In the fourth quarter, we raised prices in nearly all markets and limited lot releases in about 20% of our communities. This has allowed us to capture price appreciation and also to manage production schedules.

As discussed last quarter, in certain markets, more normal seasonal demand patterns have returned. Our ability to continue raising prices illustrates the deep strength of this housing market as well as the advantages we enjoy as America's luxury homebuilder. This week we raised prices again in all of our markets nationwide. The housing market is being driven by solid fundamentals including favorable demographics, pent-up demand from over a decade of underproduction of new homes, low mortgage rates and a tight resale market.

According to a Redfin report from last week, in the last full week of November, the number of homes for sale nationwide hit an all-time low and a third of homes sold in one week or less during the month of November.

Additionally, many Americans have fundamentally shifted their lifestyles and reevaluated where and how they want to work and live. This is driving migration patterns to the Sunbelt and Mountain States where we have significantly expanded our presence in recent years. Our build-to-order model appeals to an affluent customer base that is placing more importance on their homes and gravitating to the personalization we offer in designing and finishing homes.

They are not maxing out their mortgages and they are less susceptible to affordability issues. They have enjoyed years of price appreciation in their current homes and in the stock market. Since most of our move-up and active adult customers have a home to sell, the tight resale market gives them confidence that they can sell their home quickly and at an appreciated value that can be reinvested in their new home.

And we continue to realize the benefits of our strategic expansion into the affordable luxury segment. In the fourth quarter, approximately 42% of our new contracts were in this segment. Over the past two years, nearly half of the lots we placed under contract were for our affordable luxury communities. We believe all of these factors will continue to contribute to strong and sustained demand for our homes in the years to come.

While the environment for homebuilders remain healthy, this market is not without its challenges. Consistent with other builders and nearly every other company in the broader economy, we continue to face supply chain disruptions and labor constraints. These issues extend beyond just construction cycle times, and impact land development and municipal approvals and inspections as well. While we have been able to more than offset cost pressures with price increases, these production constraints continue to extend cycle times and put pressure on deliveries. In our fourth quarter, we saw average cycle times increase by about two weeks compared to the third quarter.

On average, it is now taking us about six to eight weeks longer to deliver a home than it took one year ago. We do not anticipate these labor and supply chain conditions will improve in the near term. Our delivery projections for full fiscal 2022 are based on production schedules that reflect current labor and supply chain conditions.

They are not based on any assumption that labor or supply chain conditions improve. Similarly, our projected 250 basis point increase in adjusted gross margin does not assume any improvement in labor or material markets. Given the high degree of uncertainty regarding when supply chain and the labor markets will normalize, we believe these assumptions are prudent.

Our land strategy continues to serve us well in this market. We're poised for significant growth in 2022 and beyond with a pipeline of owned and controlled land that will feed our projected 10% community count growth by the end of fiscal 2022. This projection is based solely on land we own or control today. We also have land under control today for meaningful further community count growth in fiscal year 2023. We continue to generate strong cash flow and have a healthy balance sheet with ample liquidity. This gives us the flexibility to continue to invest in the growth of our business while returning capital to our shareholders and reducing debt.

In fiscal 2021, we returned approximately \$455 million to shareholders through dividends and buybacks and reduced debt by approximately \$400 million. We intend to continue to prioritize growth with a balanced approach to capital return and leverage. We're targeting buybacks of approximately \$100 million per quarter in fiscal year 2022.

With that, let me turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. In fiscal year 2021's fourth quarter, we delivered 3,341 homes and generated revenues of \$2.95 billion which were up 13.6% in homes and 18% in dollars from one year ago. The average price of homes delivered was \$883,000, benefiting from more City Living and Pacific deliveries than had been anticipated. Fourth quarter net income was \$374.3 million or \$3.02 per share diluted compared to \$199.3 million and \$1.55 per share diluted one year ago.

Our fourth quarter adjusted gross margin was 25.9%, compared to 24% in the fourth quarter of 2020. This 190 basis point increase in our adjusted gross margin was due primarily to our ability to raise prices as well as favorable mix coming a quarter earlier than expected from the Pacific region and City Living noted above. SG&A as a percentage of revenues was 8.8% in the quarter, compared to 9.9% in the same quarter one year ago.

This year-over-year reduction in SG&A is due to both the leverage from increased revenues and tighter cost controls on items such as head count, advertising, model home expenses and broker commissions.

Joint venture, land sales and other income was \$63.5 million during the fourth quarter, compared to \$11.2 million in the fourth quarter of fiscal year 2020, and approximately \$20 million better than projected. The outperformance was primarily due to an asset sale in our Apartment Living business that occurred sooner and at a better cap rate than expected, as well as better-than-expected performance in our mortgage and title operations.

Our Apartment Living business had an active and productive year in fiscal year 2021. In addition to starting about a dozen new projects across the country, we sold five projects during the year with a total of 1,420 units that generated cash to Toll Brothers of approximately \$106 million and resulted in \$75 million of income from unconsolidated entities. We expect the steady flow of projects reaching stabilization and being sold each year going forward.

Last quarter, we announced a strategic partnership between our Apartment Living unit and EQR. Under this arrangement, we expect to be able to improve the capital efficiency of our Apartment Living business. We continue to explore similar programmatic relationships for markets that are not covered by our joint venture with EQR.

Impairments and write-offs totaled \$10.5 million in the quarter concentrated in our North segment. We continue to generate strong cash flow with \$1.3 billion of cash flows from operations this year. We ended the fiscal year with approximately \$3.45 billion of liquidity, including \$1.64 billion of cash and \$1.81 billion available under our revolving bank credit facility. During the year, we invested \$1.9 billion in land acquisition and development, returned \$455 million to shareholders through share repurchases and dividends and reduced debt by approximately \$400 million, lowering our net debt to capital ratio to 25.1% at fiscal year-end.

Last month, we repaid all \$410 million of 5.875% notes that were due in February of 2022 at par. At fiscal year-end we also extended the maturity of both our \$1.9 billion revolving credit facility and our \$650 million term loan. Each of these facilities is now scheduled to mature on November 1, 2026, five years out.

Our next significant public debt maturity is not until April 2023 when \$400 million of senior notes becomes due and after that another \$350 million of notes are due in November of 2025. Looking forward, we're projecting fiscal year 2022 first quarter deliveries of approximately 2,000 homes with an average price of between \$865,000 and \$885,000. Consistent with normal seasonal patterns, first quarter deliveries are expected to be the low point of the year with deliveries for the full fiscal year weighted to the second half, also consistent with seasonal patterns.

For full fiscal year 2022, we're projecting new home deliveries of between 11,250 and 12,000 homes with an average price between \$875,000 and \$895,000. In light of the challenges caused by labor shortages, supply chain disruptions and related issues with municipalities, it is important to note that our delivery projections for the first quarter and full year are based on lower backlog conversion ratios than historical trends would suggest.

We hope the construction environment improves in fiscal year 2022, but we are not factoring improvement into our guidance. We expect adjusted home sales gross margin in fiscal year 2022 to be approximately 27.5% for the full fiscal year. This is 250 basis points higher than 2021. We steadily increased prices over the course of fiscal 2021. We expect those price increases to flow through our gross margin over the course of fiscal year 2022.

In addition, we expect peak lumber prices from last year to be reflected in our first half deliveries. Therefore, we expect adjusted gross margin in the first quarter to be the low point of the year at approximately 25.5% with a modest increase in Q2 followed by significant growth in margin in the second half of the year. We expect interest and cost of sales to be approximately 2.2% in the first quarter and 2.1% for the full year.

The lower expected interest expense in our cost of sales is due in large part to the debt reduction actions that we've taken over the past 12 months. We project first quarter SG&A as a percentage of home sales revenues to be approximately 14.1% versus 14.9% one year ago. Included in first quarter SG&A is about \$11 million or 63 basis points of our normal annual accelerated stock compensation expense that will not recur in the remainder of the year.

For the full year, we project SG&A as a percentage of home sales revenues to be approximately 10.5%. Doug mentioned that we project community count growth of 10% by fiscal year-end 2022. Based on the high number of community closeouts that we project for the first quarter and the typical seasonality of fewer community openings in November and December, we expect community count to dip to 325 at the end of the first quarter before steadily rising over the remaining course of the year to 375.

Again, this projection is based on lands we already own or control. Other income, income from unconsolidated entities and land sales gross profit is expected to be approximately \$30 million in the first quarter and \$100 million for the full year. We project the first quarter and full-year tax rate of approximately 26%. Our weighted average share count is expected to be approximately 123 million shares for the first quarter, and 121.5 million for the full year. Put this all together, using our midpoints and we're guiding to fiscal year 2022 earnings per share of approximately \$10. This represents a 50% increase in earnings per share over 2021.

Now, let me turn it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. Before I open it up to questions, I'd like to thank the Toll Brothers team for their determination, creativity and commitment to make this a record year. These are very exciting times for Toll Brothers.

Tom, let's open it up.

QUESTION AND ANSWER SECTION

Operator: Great. We will now begin the question-and-answer session. [Operator Instructions] And the first question comes from Deepa Raghavan with Wells Fargo. Please go ahead.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning, everyone. Thanks for taking my question.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Good morning.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Great quarter. Looks like Q1 is turning out pretty nice as well. But just looking at the guide for 2022 and looking at the gross margins especially in the second half, you're talking about roughly 29%, 30% ex-cap gross margins exiting the year. Just curious, does it bake in the recent lift in lumber? Do you think that hits you by then? And curious, how do we – how sustainable is that if let's just say commodities don't move from here? Is that what we should be expecting in 2023? I mean it's a hypothetical question but is that what we should be expecting in 2023 if things were to stay here at this – commodities don't move from here?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Deepa, so yes, we have – we believe we have properly budgeted and built in contingencies for not just the relatively modest compared to a year ago increase in lumber prices recently. We have increased our contingencies on our building costs that are within our budgets to cover lumber, to cover some labor pressure, to cover some of the supply chain issues we talked about. So, yes, we're comfortable. I think we made it clear on our prepared comments that we believe we're very comfortable and we're being prudent in our guidance to assume that this market, the labor and supply market does not improve and in fact we have proper contingencies in to protect ourselves should lumber continue to go up or should there be any other pressure.

With respect to 2023, we're just not going to get out that far. All I'll say is as I mentioned a moment ago, we're continuing to raise prices. This is a very strong market nationwide, we had another price increase this week and to-date through this recent cycle we have been able to more than offset price increases – cost increases with our home price increases.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Thanks. Sticking on that pricing for my second question, your other pricing is up 26%, your backlog pricing is higher, it's in the teens, but you're calling for closings ASP of up 5%. What sort of conservatism is baked in that? Is it primarily some production issues? Is there some slippage? I mean you just talked about deposits being almost nonrefundable deposit. So just curious how do I – and you had another price increase this week, you just pointed out, so just curious how do I reconcile the strong pricing trends we're witnessing?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. It's a great question and it's a pretty simple answer. Historically, we do not normally deliver the price per home in the backlog because the more expensive houses take longer to build. So, as you saw the fourth quarter's sales price break through \$1 million, those more expensive homes are bigger, they are more complicated, they have more upgrades and options and they just take a bit longer to build. So, there is a lag on the upper end of the sales price and I think that is the answer. The faster turn comes from the affordable luxury and the less expensive homes and so while we're really proud of the price increases that are coming in the future revenue, that's the reason why it doesn't perfectly match what you see in our more recent sales and in our year-end backlog.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Okay. Sorry, if I can just one more part on the pricing. Closing ASP is strong considering that you're mixing more towards affordable luxury. So, within that price performance, are you able to provide color on how much is price versus mix?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Well, we had a very strong quarter in our luxury segment this year and that has influenced the average price of sales in the fourth quarter. We expect moving forward more affordable luxury as a percentage of total based on our community count and our land purchases.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Great. Thanks so much. I'll pass it on. Great quarter.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you very much.

Operator: The next question comes from Truman Patterson with Wolfe Research. Please go ahead.

Truman Patterson

Analyst, Wolfe Research LLC

Q

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

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Hi, Truman.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Marty – hey. Marty, very strong 2021 operating cash flow of \$1.3 billion. I am hoping you can help us think through 2022 operating cash flow, you should see a nice jump in that income, you're transitioning more towards optioned land, improving multi-family capital efficiency but you're likely going to continue to build backlog as well

as the cash usage. So, I'm hoping you can help us think through 2022 and then also a little bit of clarity on what you plan to do with the cash. I know Doug mentioned about \$100 million of share repo per quarter, but any debt reduction, et cetera.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Let me start with the second half of the question first and then I'll move back to cash flow from operations. We paid off \$410 million of debt already in the first quarter back in mid-November. We've guided to \$100 million of buybacks per quarter moving forward. We have a dividend commitment of \$60 million to \$70 million range. So that's let's call that \$850 million of cash usage. That's approximately what we might generate this year. It all depends on the land spend which is variable based on the deals we are going to put into land banking arrangements and the deals that we have in the pipeline that may or may not close. So, it will be another strong year of cash flow from operations as we currently project, it may not be quite as strong as the previous year.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Okay, okay. No, fair enough. And then, Doug I'm hoping on the material supply chain, it still remains tight and you said your cycle times were up two weeks sequentially in fiscal 4Q but post quarter November, December, have you seen any improvement in availability of any key materials categories or as of now have you started to see construction cycle times stabilize?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Truman, the answer is no. We've not seen an improvement. It's tough.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Yeah.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Here's a story out of Boise. For months, we couldn't get trusses. We get them, they were delayed and it really hurt construction. We've recently solved the truss problem in Boise only to find out our HVAC contractor can't get flexible duct to do the [indiscernible] (00:30:55) on the houses. So, you solve one problem and another one pops up and every market has a different story. I have spoken with the CEOs of some of our largest partners, some companies bigger than Toll Brothers and they have been somewhat encouraged by what they believe is some hope for them on solving their problems and speeding up some deliveries and having more consistency in what can be delivered.

But overall, the short answer is no, it is not improving. We don't see cycle time growing dramatically. I talked about six to eight weeks longer now than it was a year ago but as we said, we think we're being very prudent in not assuming that that gets better for the full year. I'm hopeful, I think by the second half of the year, there is some reason to hope that we're going to see some improvement but we're not building it into how we're running this company or how we're guiding the Street.

Truman Patterson

Analyst, Wolfe Research LLC

Absolutely. Thanks, guys for taking my questions and good luck on the upcoming quarter.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Truman.

A

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

Stephen S. Kim

Analyst, Evercore ISI

Great. Thanks, guys. Great job, obviously, encouraging comments and particularly I guess Doug used the word contingency that you've baked in that sounds a lot to me like conservatism but we'll take it, I think that's really encouraging. My first question relates to the supply chain issues. In answer to Truman's question, you said you're not seeing them grow dramatically, but are you actually seeing them grow continuing from end of October? We have been hearing for instance that subcontractors have been willing to sort of warehouse parts when they become available so that if in the future they become unavailable, they are still able to service their largest customers such as you guys. So wondering if you're seeing that kind of stuff and whether in fact cycle times are stabilizing and maybe that's the way to think about what's happening in 4Q – sorry, in currently.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Cycle times were up two weeks as I said from the fourth quarter over third quarter. You are right, there is a lot of meetings going on and a lot of creative ways that builders and major contractors and suppliers are trying to figure this out. Stockpiling is one very good example. We're getting tired of having to go to The Home Depot to try to find something that – as to fill a gap for a week and so everybody is on it. And I think I'm not going to go so far, Stephen as to use the word stabilize, but I also don't believe we're going to see a continued jump as I mentioned of another two weeks in Q1 versus Q4 of 2021. I think by adding two months, six to eight weeks to our delivery cycle in a year, obviously that's a lot, and it is the most acute and the most – the biggest issue that every builder is focusing on so, yes, I think we are all finding ways to try to if not solve these problems, then I'll use your word stabilize them.

A

So, yeah, I'm fairly confident that it's not going to get significantly worse, but I am less encouraged that it's going to get better for some time. Sorry for being vague, but that's as straight as I can give you. This is a very fluid situation, and every market is different. There are certain markets where the teams aren't as concerned and there's other markets where it's acute.

Stephen S. Kim

Analyst, Evercore ISI

Yeah. No, I appreciate it. I know it's a crazy time out there. But still related to supply chain and your reaction to it, got a couple – few questions kind of all around that. I was curious if you could give us a sense for how many homes you started in the quarter and how that compares with what you expect to do in the first quarter and what you did maybe in the third quarter? Same thing with how many unsold units under construction do you have at year-end and do you think that's going to increase in 1Q 2022? And then lastly, do you think your backlog can continue to rise from its current level over the next few quarters?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, about 12% of our homes are spec, which means they are starting without a buyer. That was higher a few quarters ago, we talked about it approaching 20%. But we've sold through those specs. We have huge backlogs of homes that have been contracted with a buyer that obviously have to take some priority because we have a contract on that lot, but we are absolutely committed to increase our spec inventory to increase our starts of spec homes over the next couple of quarters.

And as we begin to solve or at least stabilize some of the backlog turn, some of the construction issues, you will see us increase the number of starts. And we will in most cases hold off on the sale of those spec starts until the houses are much further along and closer to completion and so that is absolutely a strategy that is in place and I am pushing to get that 12% spec number up closer to the 20% that we were out a few months ago. Stephen, I'm sorry, did you have a second half of that or are we good?

Stephen S. Kim

Analyst, Evercore ISI

Q

The last one was just simply about your backlog, your backlogs are very high in many ways...

[indiscernible] (00:37:39)

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, right now we're selling at a pace of 40 for community and we're building at about a pace of 36. Historically, we've been able to build higher than 36, approaching 40. With the supply and labor issues out there, that's tougher right now. But are we able to grow backlog? Yes, absolutely. What does that do to cycle times and delivery dates that we quote? That's depended upon what's going on in the field and how quickly we can get houses built, but [ph] we're open for business (00:38:25). As I mentioned, 20% of our communities are on allocation, 80% are open and we're seeing terrific – terrific demand and sales activity in all of our markets nationwide, in all of our product segments, affordable luxury, luxury and active adult. And so, we're raising prices. We're on allocation where we need to be because the quoted delivery date has pushed out, but we sit today in a very strong housing market.

Stephen S. Kim

Analyst, Evercore ISI

Q

Yeah. Good times. Thanks very much, guys.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you. Take care.

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

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Morning. Thanks, Doug, Marty for taking the questions. I wanted to follow up on pricing. I think last call you mentioned some of the normalization and how maybe the national increase had turned into as much a marketing

tool as something to cover cost or expand margin. I'm wondering as you've seen some stability or strength come back to the market this fall, how would you characterize the price increase that you're putting out there this week in terms of magnitude or signaling effect?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, please understand that communities are free to raise prices whenever they want subject to I usually put my eyes on it but we don't wait for what I described this week and there are many communities that are regularly raising prices. However, two, three, four times a year we do have a national price increase which helps with sales, right, you sell into it. We also three times a year have a national sales event which is a couple weeklong sales event and we can also sell into that. This week prices went up between 1% and 5% in our communities and all of our markets nationwide.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay, great, understood and thanks, Doug. My second question just on the cadence of margins, I mean makes sense given the moving pieces. Just in terms of what that implies for the second half, I think it's – I guess it depends on your definition of modest and significant when you're talking 2Q versus 3Q, 4Q but maybe something in the neighborhood of 29% in the second half of the year. I guess, Marty, any further color on how should we be thinking about kind of the exit rate for gross margin in your guidance for 2022?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah, I think directionally you are on track there, Mike. I think 25.5% for the first quarter, a modest increase for the second quarter and then, we get up into those upper 20s for the last two quarters, more so in the fourth quarter.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

And would you say that your fourth quarter guidance, I guess given the deliveries or the constraints that you've outlined, would you say, I know you don't want to get into 2023, but the pricing that you've already put into effect that's in your backlog that is not yet fully coming through by the end of 2022? Is that fair?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

That is fair.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

That's fair to say. Yeah.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah, there's certainly some homes we're selling today that we'll not be delivering until 2023.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

There's some homes in the year-end backlog.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

That's right.

A

Mike Dahl

Analyst, RBC Capital Markets LLC

Okay. Great. Thank you.

Q

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

Alan Ratner

Analyst, Zelman & Associates

Hey, guys. Good morning. Nice results. Congrats.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Good morning. Thank you.

A

Alan Ratner

Analyst, Zelman & Associates

First question on the lot count and land acquisition environment. I know this is not necessarily representative of what you're seeing or doing today, but the sequential increase in your lot count was a lot more modest than we've seen in the last several quarters. And I'm just curious if you could kind of talk about what your appetite is for land right now? What the environment looks like in terms of price depreciation on the lot side? Obviously, you guys are – you have a lot of land which is a great position to be in this market. So, are you maybe starting to pull back a little bit on the gas pedal or is this – should I not read into that as much?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah, I wouldn't read into it. We're very opportunistic as I think everyone now understands. We're obsessively focused on how we're buying land and driving our return on investment, return on equity, and I'm very proud that we're now at 55% optioned. We'd set a goal of 45% option, we blew through that. We set a goal of 50% optioned, we blew through that. We're going to set a goal of 60% optioned, I suspect we'll blow through that. And so Q4 what was one of the biggest land spends that we had in sometime, and that was just sort of coincidental with when certain land that we tied up in prior times closed, and would require to check, so I wouldn't read much into what you're seeing there.

A

We're going to continue to be opportunistic. Our footprint is bigger. We were in 50 markets. We're now in 60 markets, and the way we have expanded and some of these smaller bolt-on builder acquisitions we've done of late, and so there is more opportunity. And as we expand affordable luxury, there is more opportunity. We mentioned that almost half of our land buys in the last couple years go to the affordable luxury segment. So, we're

not shutting it down. We're not changing the underwriting. It's still very disciplined, and so I wouldn't read much into that one quarter. I think you're going to see us continue to increase the optioned land, drive the higher return on equity, but grow.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah. And I want to take this opportunity to kind of point out that of our 36,000 or so owned lots, 10,000 of them were sold, and are in backlog. So compared to kind of other builders with the size of our backlog, our years of land supply needs to be evaluated with that sort of mentality.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right, because we're not spec builder.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Right.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

[indiscernible] (00:45:32).

Alan Ratner

Analyst, Zelman & Associates

Q

Sure. I appreciate that, guys. Thank you. The second question might be a two parter here, but the first one, just thinking about Boise as an example, you guys obviously were very early to take advantage of the strength of that market, and it seems like in the last six or so months, a number of other publics have entered that market. And in general it kind of feels like builders are back in expansion mode, they hadn't necessarily been entering new markets as much as they have been over the last six or nine months. So just thinking about your observations in the market like Boise for example, does that create any type of competitiveness or incentives or any change in market dynamics when you have a number of builders entering what seems like a fairly hot market over a short period of time?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Well, Boise is a good example. I mean we couldn't keep it a secret any longer. In fact, I didn't do a good job of ever keeping it a secret because we were doing so well and so proud of it. But there is no question you prefer when the other big publics aren't in the market and you've a dominant position. We have a huge head start there, and we have many thousands of high quality and expensive lots. So there, Alan, is an example where we can be a bit more conservative in our land buying because of the land position we have built, but yes as some of these markets become a bit more competitive with larger players in the market, you have to find your niche, and I think we really good at that.

We're going to come in at a little bit higher price. Even our affordable luxury is a little bit higher price. We're not going to be all spec. We're going to offer people choice. People today even at a lower price they want some level of choice. The home is so important that they want some opportunity to design it to their lifestyle, and so we work

hard even in really competitive markets of finding that niche, and I think that's distinct to Toll Brothers, and we're going to continue to take advantage of it, but you're right, as markets get loaded up with bigger builders, they become more competitive, and you have to be more careful, and you have to find the right opportunities that fit your business plan.

Alan Ratner

Analyst, Zelman & Associates

Q

Makes sense, Doug and your response to that kind of segues into that third question I wanted to ask was just that with the cycle times becoming so elongated for you guys, and the fact that even though you're trying to put a few more specs on the ground, you're never going to be as spec focused as a number of other builders. Have you seen any sign of consumer pushback in the sense that, especially in that affordable luxury price point where maybe you're getting more renters coming to those homes that need to move fairly quickly? Did that extended cycle times now would turn off to them and they're not willing to move forward, and they're looking for something that they can be in a little bit quicker, or is it not at that pain point yet?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Well, rents are up dramatically. Interest rates are still very low, so we're not – I'm not hearing that people come in and say, boy, I'm really disappointed it's now 12 months to get that house set. Last year I could have gotten from you [ph] at 9.5 (00:48:55) and I'm going to go rent. Maybe they'll rent while they wait for the 12 months. There you go, it's a 12-month lease. They'll wait until their house is completed. But – so, I don't think we're feeling it particularly at our price point even in affordable luxury of the rents' decision versus the owned, but there is a, I think it's a small part of the market that as delivery dates get pushed out, they become a bit concerned as to whether they want to wait that long, and they may go look for other opportunities.

Now the resale market is so incredibly tight that I'm not sure they're going to find it there, and all the other builders in the market are pretty busy, so I'm not sure you're going to find it there. Could there be some spec inventory, new home spec inventory? Possibly. But again the question is, do I want the spec that is not exactly what I want, or I want to wait a bit and get exactly what I want, because I can modify it a bit with Toll. So, there is some modest pressure, but we're not feeling it to any extent that's affecting demand or affecting pricing power or affecting our sales pace.

Alan Ratner

Analyst, Zelman & Associates

Q

Got it. Okay. Great. Thanks a lot. I appreciate the responses.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome, Alan. Take care.

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

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Hi. Thanks very much for taking my question. Good morning and congrats on all the progress and the great results.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Mike.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

First question. I just wanted to circle back and I don't want to beat a dead horse and it's not easy to talk about 2023, 2024, but you've had a couple questions about the exit rate on the gross margins. And I think one of the big concerns for this sector overall, not just Toll, is the sustainability of those margins as they're approaching prior peaks. And what potential trajectory you might see in the out years, in the next couple years? Given the still very strong pricing power that you have in the market, that's continued as you've noted, how are you thinking about the potential tailwinds and headwinds as you think about 2023, 2024, and relative to the sustainability of that exit rate that you're looking at in 2022?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Mike, all I can say to that because we're not going to get out that far is that all of our geographies and all of our different product segments are seeing gross margin expansion today, and that is with contingencies we put in place to cover certain level of cost increases or uncertainties that are out in the market. I'm not going to predict as far as you talked about how that gross margin compares to industry historic highs, I can't even predict how it compares to today except what I just said. All geographies, all product types are seeing gross margin expansion of the next home sold at this moment in time.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

Okay, appreciate that. I guess secondly, you mentioned your, I believe it was non-binding deposits for the first five weeks kind of continuing the pace over the last few months and similar to what you saw last year. Your absorption rate on average for fiscal 2021 was in the low 3s per month, 3.2, 3.3. Is that a good way to think about the business during the upcoming year assuming current demand trends persist? And would you expect to see within the year the higher rate, did almost 4 per month in the second quarter obviously that's the strong seasonal quarter but given the fact that now only 20% of your communities are on allocation which means that you're kind of selling at a perhaps closer to market let's say I would think, is that type of a sales pace kind of how we should think about the business here over the next 12 months?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Well, as I said, we were delighted that our five weeks of deposits equaled the same five weeks at the end of calendar 2020, first month of Q1 fiscal 2021. Remember, Q1 of 2021 sales were up 59% over Q1 2019. We were hot. I am sorry, my apologies 2020. So, for us to achieve – it's only five weeks but for us to achieve deposits that match a year ago when that quarter a year ago was up 59% over the prior year, we're very encouraged.

A

The cadence for the year as you described, you know our cadence, generally December and January are not the strongest months for sales and then February, the spring season kicks in and then off we go with the spring selling season. I've mentioned that there's some signs of seasonality in some of our markets and many other markets there aren't signs of seasonality.

Last year there was no seasonality, didn't matter what week of the year it was, we just kept selling. So, all I can say to that, Mike is because we're not going to predict our sales going forward, we have the land, we have community count growth coming, we have an incredibly wide net now with geographies and price point and we've had a terrific start to Q1.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Great. Thanks so much. Good luck.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Mike. Take care.

A

Operator: And our last question comes from Rafe Jadrosich with Bank of America. Please go ahead.

Rafe Jadrosich

Analyst, BofA Securities

Hi, good morning. It's Rafe. Thanks for taking my question. Firstly, you mentioned lifestyle changes and migration shifts in your prepared remarks. I just wanted to ask what kind of – what are you seeing that gives you confidence that this is a sustainable trend and it's not just temporary? And then within that, can you just talk about the demand you are seeing for second homes?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah, I'm sorry. I misunderstood the first half.

A

Rafe Jadrosich

Analyst, BofA Securities

Consistency of migration patterns we're seeing.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Why is it long-term?

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. So, we look at the U-Haul pricing charts. They obviously have surged pricing. If you want to move a load from New York City to Palm Beach, you're going to pay \$4000. You want to get that U-Haul back to New York for another load, they may pay you a drive at north and those trends exist from California to Austin and California to Reno and Vegas and Phoenix and the North Charleston and Florida and I think those trends are real. I mean

A

before COVID people were leaving the Northeast, chasing the sunshine, chasing the jobs, chasing the lifestyle, chasing affordability.

And the same thing for the West, the expensive state of California we're doing really well in California. There is 40 million people and if a half a million decide to leave, we still got ourselves 39.5 million that want to stay there and pay the price to enjoy that Pacific Ocean but those migration trends existed before COVID and they have accelerated and I think are firmed up longer term because when COVID is long gone, the mentality of people to live where they want to live to take a job that allows them to have flexibility and where they can work at least part of the time to design the home to their lifestyles.

Early on we were marketing, my home is the most important thing in the world, my home is my sanctuary. This is real. People care more about their home, they're spending more time there and they're concentrating on how they can design it and they are moving to where they are allowed to move to enjoy their life versus where the job had tethered them and so I feel strongly these migration patterns Sunbelt, Mountain States existed before COVID and will long outlive this moment that we are in.

I just look at – we have states like Idaho, Florida, Texas, North Carolina, Nevada, Arizona, Colorado, 40% in some cases of our buyers coming in are coming from a different state, and that's going to continue.

Rafe Jadrosich

Analyst, BofA Securities

Q

Thank you and then just to follow up on this. You spoke a little bit about how your affluent customers are less concerned about affordability. I know mortgage rates have stayed stable and low but if they do move up, how do you think about the willingness of your kind of core affluent buyer to trade up?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah, it's a great question. We ran the math. If rates go up by 150 basis points, call it, ran a quarter to four and three-quarters, 5% of our backlog would have to figure out either mortgage less or go to an adjustable product, only 5% and that's because 20% are all cash and those that get a mortgage have an average LTV of 69%. They have a lot of equity coming out of their existing home, they've done well in the stock market so that's the backlog.

Your bigger question about how would the buyers react to it, I'm not – I can't sit here and tell you that Toll Brothers is immune to affordability and immune to higher interest rates but we're in a much better position because of the nature of our buyer for all the reasons that we have given. The other thing as we have – as the loan limits have gone up on conforming loans, they've gone up by \$100,000 and that's moved about 6% of our backlog from a jumbo down into a conforming and that's also very encouraging, \$100,000 average move in the loan limit of conforming and so I think that's a nice tailwind for our business.

Rafe Jadrosich

Analyst, BofA Securities

Q

Great. Thanks for all the color.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome.

Operator: This concludes our question-and-answer session. I'll turn the conference back over to management for any closing remarks.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Tom and thanks, everyone for your continued interest and support. We wish everybody a wonderful holiday season and a healthy and happy 2022. Thanks.

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

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