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Toll Brothers, Inc. (TOL)

Q1 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Toll Brothers First Quarter Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] The company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourself to one question and one follow-up. Please note this event is being recorded.

I'd 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, Jason. Good morning. Welcome and thank you for joining us. With me today are Marty Connor, Chief Financial Officer; Rob Parahus, President and Chief Operating 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 material, inflation and many other factors beyond our control that could significantly affect future results

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I will begin by sharing some thoughts on current market conditions and sales, along with the challenges we are seeing on the production side and how we are addressing them. I will then turn it over to Marty to discuss the numbers and guidance in more detail.

Our first quarter results were solid. Net income and earnings per share rose 57% and 63%, respectively, and home sales revenues grew 20% in dollars and 9% in units compared to last year's first quarter. Our adjusted gross margin of 25.6% in the quarter was 270 basis points better than last year's first quarter and our SG&A expense as a percentage of home sales revenue improved 150 basis points over last year.

At first quarter end, our backlog stood at a record $10.8 billion and 11,302 homes. Due to the strong demand we continue to see in the market and the good visibility that our backlog provides, we are reaffirming all of our full year guidance.

We are pleased with our sales results in the first quarter as we saw broad strength across all of our buyer segments and geographies. We signed 2,929 net contracts for approximately $3 billion, up 2% in units and 19% in dollars over last year's extremely strong first quarter when orders were up 59% in units compared to fiscal Q1 of 2020. Our contracts per community at 8.8 for the quarter remained well above historical averages. This was our best first quarter sales ever.

The average selling price of signed contracts in the quarter once again exceeded $1 million and was up approximately $149,000 compared to last year's first quarter. Favorable demand dynamics allowed us to continue raising prices in nearly all of our communities throughout the first quarter.

While demand has remained strong, we continue to face challenges on the production side from supply chain disruptions, labor shortages and municipal delays. These challenges were compounded by additional pressure from the Omicron wave as it spread across the country, especially in January when it peaked.

It is taking us approximately two months longer to deliver a home today versus one year ago. It's important to point out that these delayed deliveries are not lost. We continue to enjoy historically low cancellation rates and our contracts are supported by an average non-refundable down payment of $71,000. It is simply a timing issue.

With demand and pricing as strong as they have been and with construction schedules that continue to extend due to supply chain, labor and similar issues, we believe the right strategy for us at this time is to limit sales and continue to focus on production. Over the past six weeks, we increased the number of communities on allocation from 25% to today over 50%.

In many communities, we are using the traditional resale process of best and final sealed bid to maximize price. In addition, we are starting more specs in the second quarter than we typically would to replenish inventory sold last year. As a reminder, spec homes normally represent about 20% of our settlements.

It is important to note that this increase in spec starts and purposefully metering sales should not impact the timing of future revenues, as we expect the spec homes started in Q2 to be sold later in the construction process and still be delivered in the first half of 2023. So, we expect to start more homes than we sell in Q2 and we expect our sales pace in the second quarter to be similar to the 8.8 contracts per community that we booked in the first quarter.

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Our non-binding deposits in the first three weeks of February were consistent with the pace of the past nine months, which was approximately 325 deposits per week. We could have taken more deposits these past three weeks, but we chose not to in order to focus on production and manage build times.

In order to further streamline our operations and mitigate potential production bottlenecks, we also continue to optimize the number of available floor plans and options we make available in a given community, offering buyers better choices by focusing on those that are most popular and more readily available. And we continue to work closely with our subcontractors and national suppliers so we can anticipate supply chain issues and labor delays and make any necessary adjustments.

While we do not anticipate any meaningful improvement in supply chain and labor shortages in the near term, we are encouraged by the recent steep drop in COVID cases and the relaxing of many pandemic restrictions.

Turning back to the demand side of the equation. The housing market and demand for our homes in particular is being propelled by strong demographics from both the millennial and boomer generations, a substantial imbalance between the tight supply of homes and continued pent-up demand, the wealth effect of rising existing home equity, migration trends and the greater appreciation for home. We believe these long-term tailwinds will continue to support demand for our homes well into the future.

We continue to see people move from states where home values, taxes and cost of living are higher to less expensive regions. This dynamic is spurring demand in markets across the country and particularly in the Sunbelt and Mountain States, where we have expanded in recent years. For these buyers, affordability is less of an issue. We have also not seen an impact on demand from the recent increase in mortgage rates.

I remind you that our customers are generally better insulated from affordability concerns compared to buyers in the entry level market. Our buyers tend to have higher incomes and they benefited from multiple years of appreciation in their investment portfolios and their existing homes. They also understand that when they contract with us today, their interest rate will not lock until they are much closer to settlement. So, we don't believe that demand for our homes is being pulled forward by buyers who are focused on beating a rise in rates.

Also keep in mind that rates have no impact on monthly payments for about 15% to 20% of our customers who pay all cash. And that another approximately 30% of our buyers borrow at jumbo rates, which are currently 0.625 point lower than conforming for our clients. And overall, our customers average less than 70% loan to value in their mortgages.

In fact, we've analyzed our backlog and estimate that rates would have to increase to approximately 5.25% before just 10% of our backlog would need to consider an arm, a higher down payment or other alternative mortgage. This speaks to the creditworthiness and healthy balance sheets of our customers.

As I mentioned earlier, we are reaffirming all of our guidance, including a return on beginning equity for fiscal 2022 of approximately 23%. We also expect to generate substantial cash flow in 2022. Our highest capital allocation priority continues to be investment in the growth of the business, including through disciplined and capital-efficient land buying.

Of the approximately 86,500 lots we owned and controlled at January 31, 54% were optioned and 46% were owned compared to 46% optioned one year ago. Our shift to more optioned lots is an important part of our capital efficiency strategy and our focus on returns. This lot position also provides us with all the land we need for our projected community count growth in fiscal year 2022 and beyond. We continue to expect approximately 10%

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community count growth by the end of fiscal 2022 from the 340 communities we were operating at the end of fiscal 2021.

We continue to use excess cash to further reduce leverage and return capital to shareholders. In the first quarter, we repaid $410 million of our senior notes. We also repurchased $185 million of our stock, which reduced our outstanding share count by approximately 2.5%, and we paid dividends of approximately $21 million.

Our balance sheet remains strong with ample liquidity, strong expected cash flow generation and declining leverage. These factors, along with the positive fundamentals underlying our business, contributed to Moody's upgrading us to an investment-grade credit rating last month.

With that, I'll turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. In our first quarter, we delivered 1,929 homes at an average price of approximately $875,000, generating homebuilding revenues of $1.69 billion, which was up 9% in units and 20% in dollars from one year ago.

Settlements came in 71 units below our expectation due to the supply chain disruptions, labor shortages and municipal delays that Doug mentioned. We felt the greatest impact in January, the last month of our quarter, as the effects of the spread of Omicron were most acute. Fortunately, Omicron and the pandemic now seems to be waning.

Our first quarter pre-tax and net income were $200.8 million and $151.9 million, respectively, both up approximately 57% compared to $127.4 million and $96.5 million, respectively, in the first quarter of 2021.

Earnings per share in the first quarter were $1.24 per share diluted, up 63% compared to the $0.76 per share diluted that we earned one year ago. The net income and earnings per share growth percentages were approximately triple our revenue growth percentage growth.

Our first quarter adjusted gross margin was 25.6% compared to 22.9% in the first quarter of 2021. The 270 basis point improvement reflects the strong pricing environment over the last year. It also includes the impact of elevated lumber prices from last spring in this quarter's closings. We continue to project an adjusted gross margin of approximately 27.5% for the full year.

We expect adjusted gross margin of 25.5% for the second quarter of fiscal year 2022 as the impact of elevated lumber prices from last spring continues. This will be followed by a ramp-up in our gross margin in the third quarter and a greater ramp in our fourth quarter.

SG&A as a percentage of revenue was 13.4% in the first quarter compared to 14.9% in Q1 of last year and 70 basis points better than projected. Joint venture, land sales and other income met our guidance at approximately $30 million in the first quarter. Impairments and write-offs were $2.2 million in the quarter. Our tax rate in the quarter was 24.4% compared to guidance of 26%.

Turning to future guidance, we are projecting fiscal year 2022 second quarter deliveries of 2,350 homes with an average price between $865,000 and $885,000. We are maintaining our full year delivery guidance of between

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11,250 and 12,000 homes with an average price between $875,000 and $895,000. Deliveries will be back-half-weighted and will be consistent with seasonal patterns.

We expect interest in cost of sales to be approximately 2.1% in the second quarter. We project second quarter SG&A as a percentage of home sales revenues to be approximately 11.9%. For the full year, we continue to project SG&A as a percentage of home sales revenues to be approximately 10.5%. We expect community count to be approximately 330 at the end of the second quarter and 375 by fiscal year-end.

Other income, income from unconsolidated entities and land sales gross profit is expected to be approximately $5 million in the second quarter and $100 million for the full year. We project a tax rate of approximately 26% for the second quarter and 25.8% for the year. Our weighted average share count is expected to be 121.5 million for the full year and 122 million for the second quarter. Based on all these factors, we continue to project approximately $10 per share in full year earnings per share and a return on beginning equity of approximately 23%.

Now, let me hand it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Marty. This month, FORTUNE magazine named us the Number 1 World's Most Admired Homebuilding Company. This is the seventh time we have received this high honor. I would like to thank all of our Toll Brothers team members for achieving this tremendous recognition. They continue to demonstrate their dedication to our brand and our customers. And for that, I am very proud and very grateful. As Toll Brothers enters its 55th year in business, I'm excited about the current market and the long-term prospects for our company.

Now, let me turn it over to Jason for questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. We'll now begin the question-and-answer session. As a reminder, the company is planning to end the call at 9:30 when the market opens. [Operator Instructions] Our first question comes from Anthony Pettinari from Citi. Please go ahead.

Asher Sohnen
Analyst, Citigroup Global Markets, Inc.

Q

Hi. This is Asher Sohnen on for Anthony. Thanks for taking my question. I guess, my question is, the last time we saw rates rising in 2018 timeframe, your sales pace did slow down meaningfully. So, I was just wondering what were maybe some of the early warning signs in 2018-2019 timeframe that were showing the demand than maybe we should be looking for around now. And then, I know you haven't seen any impact on demand yet, but have any of those warning sign metrics started to weaken for you at all?

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

A

Very good question. The warning signs are web traffic, foot traffic. And right now, web traffic and foot traffic is up significantly.

Asher Sohnen
Analyst, Citigroup Global Markets, Inc.

Q

Okay. Thanks. As a follow-up, I just want to – so thinking about your sales pace in 2021, you sold maybe a little over three homes per community per month in the quarter, similar to that. And then, I think for 2Q, you expect to do the same. So I'm just wondering, looking out for the rest of the year and then maybe even beyond that, is that sales pace sustainable, maybe like a new normal, or should we think about that 10% growth in community count coming more maybe at the cost of a little bit more of a normalization in sales pace?

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

A

So, right now, we're selling at about a pace of 37 homes per community per year. And we're settling at a pace of about 35 homes per community, because of all the – everything that all the builders have talked about and what we talked about in our prepared comments earlier. We can and we will get the settlement pace higher as supply chain, labor issues, improve over – I think it's going to be the later part of this year.

As I talked about, we're going to be focused on more starts this quarter. We're about 600 spec or, what we call, quick move-in homes behind because so many of those were sold over the last year and a half through the heat of the market. And we are committed to get many more homes started in the second quarter, and that's why we put over 50% of our communities on allocation. And so, longer term, we are very comfortable being in the high-30s in both a sales cadence and a delivery cadence. And so, community count will certainly contribute to our growth, but there are opportunities as supply chain labor settles down for us to, we believe, both sell and deliver more homes.

Asher Sohnen
Analyst, Citigroup Global Markets, Inc.

Q

Perfect. That's very helpful. Thanks. I'll turn it over.

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

Stephen S. Kim
Analyst, Evercore ISI
Q

Yeah. Thanks very much guys. Really great info regarding the buyers and all the factors you ran through about demand not being pulled forward. So, thanks for that. One of the things that I wanted to – that our model is spinning out that I thought was interesting is, we have your net debt, based on what we see here, easily moving back down into the low-20s. And I guess my question was, in your outlook for return on equity of about 23%, can you give us a sense for what kind of range of net debt to cap you're expecting at the end of the year?

In addition, you've talked about specs here a little bit more. You're one of the few builders that doesn't actually give us a detailed breakdown of the number of homes you have under construction at any point in time. I was wondering if you could give us that number. What it was this quarter and what it was in the year-ago period?

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

So, Stephen, with respect to the debt question, I think you're directionally accurate. I think we're interested in operating in the low- to mid-20s, but the timing of land opportunities or builder acquisition opportunities can always impact that from quarter to quarter or from year-end to year-end. We're encouraged by the fact that our plans have been shared with Moody's and they moved us up to investment grade. And so, we feel very comfortable operating in those levels with the liquidity we have, the cash generation we foresee and the growth opportunities we have on balance sheet or in process.

With respect to your second question, which is the number of starts, I don't know that we have that with us this morning. As Doug mentioned, a lot of our starts in the second quarter will be to replenish our depleted spec inventory. So, we expect to start in the second quarter in the neighborhood of 3,400 to 3,600 units.

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

And Stephen, in the first quarter, we did start about as many homes as we sold. But last year, when we were selling a bit more homes than we were starting, and that, again, is one of the main reasons that we have increased allocations for the moment. We are going to replenish the spec count. And so, this quarter, as Marty said, we will be starting more homes than we sell. But those homes will – in fact, they should have a shorter construction cycle time, because at least in the early stages of the home, we don't have a client and we're able to move faster. But they will, we believe, deliver in the timeframe as if they had been sold. And if this market continues, we are hopeful that maybe there is even more margin in those houses because they're sold a bit later in the cycle time.

Stephen S. Kim
Analyst, Evercore ISI
Q

Yeah. No doubt. One of the interesting things that times like this brings is the higher margin on specs. Second question I had for you relates to the fact that you're trading pretty darn close to your book value, which, as I've thought about that, one of the things that we've analyzed is how much of your land that you own, how many lots you own, likely reflect pre-pandemic pricing? The analysis that we've run suggests that, based – easily all of it could theoretically have been – have had prices that were negotiated pre-pandemic. But there's two assumptions in there. I was wondering if you could comment on those.

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One is that your land values rise more significantly even than the rate of home price appreciation that land values rise, I've heard 2x or whatever of home price appreciate. I wanted to sort of check that. The second thing is, you have options, and my understanding is that some of those options have some form of escalator, but the escalator usually is sort of capped out, right? So when you have this period where land values have risen radically since the last two years, your escalators don't move up at the same rate. So, you really do have an embedded arbitrage on anything that you had as an option at the time of the pandemic. Are those two assumptions roughly correct?

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

It's a very, very complicated answer, and I don't want to bog down. But let me start with the land that we own that was contracted for pre-pandemic, that number is 77% of the land we own was tied up pre-pandemic. With respect to the deal structures, most of our deals have what we call kickers – no kickers. So, we pay for the land. We may not pay all upfront. With our obsession with capital efficiency, we may be paying over time. There may be a interest rate associated with paying over time. Certainly, with a land banker, there is an interest rate associated with taking that land down later. But most of our deals don't have a kicker, which means a land seller is participating on the back end with our success.

However, there are some deals that do have a kicker, where they are either having a revenue share on the back end, based on a small percentage of the price the home ultimately sells for, or in a very, very, very limited case, there may be a profit participation where they have to get into our books and understand how we calculate profit and we have some arm wrestling over accounting and they actually get to participate on the profit side. So one is revenue, which is a percentage of the home price itself, and the other would be a share of the profit made. But those are the exceptions.

Most cases do not have that. But to your point, when they do have a revenue or profit participation, we have the outsized component of that. So, we are benefiting far more than our seller as our prices or our profitability goes up.

Stephen S. Kim
Analyst, Evercore ISI
Q

Yeah. Makes sense. Thanks very much, guys.

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

You're very welcome.

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

Alan Ratner
Analyst, Zelman & Associates
Q

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

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

Hey, Alan. Good morning.

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Alan Ratner
Analyst, Zelman & Associates

Doug, I'd love to follow up, I think, on a comment you made to a prior question about the supply chain. And I think you kind of made a hopeful comment that as the year goes on, maybe things will at least stabilize or maybe even improve a bit. And I'm just curious your thoughts, because you guys seem to be following a similar playbook that a lot of the industry is right now in terms of limiting sales, ramping spec starts. Obviously, community count is going to be growing a lot.

So, I guess, where I struggle a little bit is, and I'd love to hear your thoughts are, why would the supply chain stabilize if the industry is all kind of trying to ramp up the volume of specs over the next three months, six months? Community count's going to be growing double digits for just about everybody over the next nine months. What is the catalyst that would actually cause the supply chain to stabilize or even improve?

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

Yeah, it's a great question. And I just want to start by explaining that we haven't modeled for any improvement. The guidance we've given, in fact, we've increased our contingencies and our building costs recently to be more careful. So, all the guidance we're providing and the way we're running this business is assuming that there will continue to be significant stress and there will continue to be significant pricing pressure.

With that said and returning to my comment I made a few minutes ago, I'm just looking at the world today. My – January, 9 million Americans called in sick. That's off the chart – off the chart to the normal, I don't know, 2 million or 3 million pre-COVID. I think the prior peak to that was a year ago when it was 6 million. January was a really, really tough month. We felt we couldn't get building inspections, because the inspector was home. We couldn't get COs because the town clerk who processes the CO was home. Our employees were home. Truck drivers were home.

I saw it in my kid's school. We saw it in our personal lives with friends and family, and that is changing dramatically. Mask came off my kids last week going to school. There is a lot that's changing rapidly that just gives me some optimism that things will be more normal. The LA – Long Beach Port, you don't have 100 freighters sitting in the harbor. You don't have thousands of containers sitting on the dock. I've heard the big suppliers are now beginning to talk about some improvements they're seeing in their opportunities to run their factories full speed to get the truckers to transport.

And so, Alan, that was the extent of it. I mean, I agree with you, the builders are growing. There is a lot of action out there. The market continues to be really strong. And so, of course, that's the other side of the equation. But I am hopeful and cautiously optimistic, using an old term, that as this year progresses, we're going to see a bit of a more normal, although still somewhat stressed, production environment.

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

I think to follow on to that a little, Alan, we are offering product that we know is available. We are choosing product in these spec homes that we are building that we know is available. And we are narrowing to the most popular items what is offered in our design studios. And that actually marries with what the manufacturers are producing. They've narrowed how much they produce to drive efficiency.

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Alan Ratner
Analyst, Zelman & Associates

Got it. Appreciate the comments there, guys. I know it's a tough environment to predict here. So, it's helpful to hear how you're thinking about it. Second question, would love to just dig in a little bit in terms of the mix of your business. I think one of the areas that, perhaps, there was some optimism on in terms of navigating some of the extending cycle times was the growth in affordable luxury and the growth in newer markets where, perhaps, cycle times historically have not been quite as extended as the coast.

So, I'm curious if I look at your average price growth, it's been very strong, kind of consistent with the broader industry. So, it doesn't seem like there has really been much of a mix towards more affordable product or kind of more affordable markets. Your cycle times, obviously, have not yet stabilized. So, should I interpret that that you're actually just seeing incrementally stronger demand from the luxury higher-end price point, or is that not the correct interpretation and there is something else going on underneath the surface there?

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

No, we're committed to the affordable luxury business. We're committed to these new markets that, as you point out, tend to be a bit lower priced. There is a lot less city living in 2022. There is almost no city living deliveries in 2022 because of the timing of buildings and our intentional decision to slow that business down as COVID hit. And the move out of city living has ramped into active adult, age-restricted primarily. But we're raising prices everywhere. So, don't read into this $1 million-plus sales price of the last two quarters to suggest that it's coastal, it's very expensive places. We entered Boise four years ago, selling houses at $325,000 and our average house in Boise now is $650,000, guys, plus or minus. And I can tell that kind of story to many markets around the country.

I guess, there is a bit of a new definition to affordable, and many of these markets are seeing equal or higher percentage increase in sales price to some coastal regions. And then, when you mix it all together, the price is coming out over $1 million. But we like the mix. Much of the land we're buying continues to be in these new lower-priced markets, where we will be able to offer more affordable homes. But as I said, those homes are going up just as fast or faster than other areas. So, it's no change in strategy. It's just prices going up everywhere.

Alan Ratner
Analyst, Zelman & Associates

All right. Appreciate the thoughts. Thanks a lot.

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

You're very welcome. Thank you.

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

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Hi. Good morning, everyone. Thanks for taking the question. A pretty – a broad one for me. If your 2022 is more or less locked in at this time, just given your backlog visibility, et cetera, what's driving that wide range in guide? Is

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that – are you waiting for spring selling season or supply chain still the governor to the high end, low end? Any thoughts there.

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

A

Yeah, the – go ahead, Marty.

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

A

So, I think our guide for deliveries is a width of 725 (sic) [750] units, right, 11,250 to 12,000, with roughly 10,000 of those to go. I think that's a prudent guide in this operating environment.

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

A

Sorry, 10,000 to go. I misunderstood, sorry.

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

A

Well, we delivered 1,929 in the first quarter.

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

A

Got it. So build 10,000 to go to deliver. Got it. Yes. I think that the reason for that range, it's not sales. We're selling in 2023 and we're very – I said last quarter that the next home sold by us in December had the highest margin we've seen in this cycle. I can repeat that comment now three months later that the next home sold today has the highest margin we've seen in this quarter because we continue to raise prices more than costs are going up. But that's a 2023 comment.

As to 2022, it's supply chain. We missed deliveries in the first quarter. We've given you guidance in the second quarter on deliveries. Obviously, we have a lot to do in the second half. If we hit our delivery guidance in Q2, 63% of our full year deliveries to hit the midpoint of guidance would occur in the second half. Our 10-year average for second half deliveries is right at 60%. And we've studied the construction status of the backlog, and it is further along than it has been historically.

So, we are comfortable that we can get to that 63% for those reasons. But we think it's prudent right now to keep that 750-unit window, because of the environment we're building in. There are some quick move-in spec homes that will still need to be sold. But with the market conditions, I think that's a very, very low risk of impacting the ultimate delivery number. I think that conservatism right now is simply based upon the production environment we're living in.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC

Q

Thanks for that. That's helpful color. Another broad one for me. You addressed a little bit in your prepared remarks, Doug. There is a bare narrative out there that luxury builders are a little bit more price elastic. And the first move down usually happens in that portfolio, resulting in luxury builders, perhaps, moving buyers to other categories, as the buyers trade down in this high interest rate environment. How would you address that?

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

We disagree. I think our buyers are much more financially sound. I went through the numbers on their creditworthiness. I went through the numbers on the average LTV is 70%. Yes, a luxury home is a discretionary buy, we understand that. But when we look at prior cycles, we've been the darling of the industry at times when rates have gone up, because the buyers can still afford our homes. It is not a monthly payment decision. Our buyers don't think – maybe except in Detroit, where they lease a lot of automobiles, they don't think about monthly payment. They think about moving up in their lives. They think about getting that larger home as the kids hit middle school, buying that second home, moving down as boomers into that luxury community. And they have the bread. They have the ability, they can afford it. They don't max out the mortgage.

50% of our buyers or more today are move-up. And the percentage that have a home to sell is 70%?

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

70%, yeah.

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

And look at the equity that's been generated in those existing homes for 70% of our client that allows them to move up. So, that little tick in rate up of 25, 50, 75, even 100 basis points, historically, we were not 100% immune, but we have been in a better place than the starter home business where it comes straight down to monthly payment and affordability.

Deepa Raghavan
Analyst, Wells Fargo Securities LLC
Q

All right. That's great color. Thanks very much. I'll pass it on.

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

You're very welcome. Thank you.

Operator: The next question comes from Truman Patterson from 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

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Hey. First, just wanted to hop back to one of the questions on the early warning signs, and as a portion of your orders, your cancellation rate ticked up about 1 point year-over-year. Just seeing if you had any more clarity from the field, is this just simply cancellations in the normal course of business, or are you beginning to see the higher mortgage rates impact some buyers' ability to qualify for the mortgage?

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

A

Truman, I think the cancellation rate is low by our historical standards. I'm looking back at the last 10 years, and 6% looks like our long-term average. It was extra low last year. It's ticked up a little bit this year. A lot of that tick up's a function of how large the backlog is right now. If you look at cancellations as a percentage of backlog rather than as a percentage of current quarter sales, they've hardly moved at all. And we are not seeing an early warning sign, if you will, in cancellations. So, I think that's a bit of a red herring as it relates to having gone from high-3s to high-4s as a percentage of new contracts. It's 1.4% of backlog. It was 1.3% of backlog a year ago.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Terrific. Thank you. And then second...

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

A

And in a rising price environment, cancellations are an opportunity for us right now, because we get to sell the home at a higher price.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Okay. So, cancellations are still beneficial for the gross margin? Okay. And...

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

A

Not a strategy.

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

A

That is not a strategy.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Fair enough. And then, second question on rate locks. Are you seeing consumers beginning to use rate locks more frequently? Are they using longer rate locks? And if so, how should we think about the cost associated to Toll and where it might impact the income statement?

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

A

We have not yet seen extended period of time rate locks be asked for by our customers. They can lock a mortgage generally in a normal course within 60 to 90 days of closing and we are seeing them take advantage of that opportunity.

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

A

Right. And I want to reiterate, 80% of the homes that we're selling are build to order, right? That's our special sauce at our price point. And those homes today will take 9 to 14 months to deliver, based on where they're located, how much backlog and production issues. And so, the commentary I hear that there is this pull-forward of demand, because buyers are trying to grab a rate today before it goes up, is just not the case. Our buyers are not able to lock on our homes until 60, maybe 90 days before that home delivers. And we are seeing tremendous demand and tremendous pricing power, in the last month, as rates have risen and buyers know that they are not running in to lock a lower rate when they buy a home from Toll Brothers.

Truman Patterson
Analyst, Wolfe Research LLC

Q

Yeah, it's interesting when you say that if you actually look at the data historically, you're exactly correct that it kind of dispels the pull-forward narrative. So, thanks for taking my questions. I appreciate it.

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

A

Very welcome. Thank you, Truman.

Operator: The next question comes from John Lovallo from UBS. Please go ahead.

John Lovallo
Analyst, UBS Securities LLC

Q

Good morning, guys, and thank you for taking my questions as well. The first one is, curious how many communities you're implementing that best and final sealed bid in. And along those lines, how do customers tend to react to that process? And do you risk pushing some buyers away that maybe chose to purchase a new home to sort of avoid this process?

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

A

So, about 90 of our, 300-and-call-it-30, plus or minus, communities are currently using the best and final offer program. That may not be for every lot. Sometimes, we do it for special home sites where we know we have outsized demand. I know on my last call, I gave some great detail on how that process works and how you can do it in a build-to-order environment, because we're not generally bidding a finished spec home, although we'll do that – we'll also do that. And if you recall, we do it through the lot premium. And then, if you are successful in bidding up the lot premium, you can then pick your house and go through the process of customizing the home to your lifestyle.

Buyers – it's how you manage the process. And sales has been really well-trained in how they manage the process. If there are 30 people that want a home site, those that are 25, 26, 27 on the list are pretty happy we're running this process, because at least they have an opportunity. Not everybody is happy, just like not everybody is happy on a resale when it goes to final and best. But that is the environment that we are in at the moment. Buyers are used to it through the resale market. We now have a really cool app, where you can bid through a Toll app that makes it totally transparent.

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And so, I think we've done a really good job of explaining it. It's a bit of a new normal in the industry. But, yes, is everybody happy with it? No, people want to walk in and buy a house off a price sheet. But that's not the environment we're working in at the moment. And I'm proud of how we're handling it. I think most buyers are understanding of it.

John Lovallo
Analyst, UBS Securities LLC

Q

Yeah, that makes a lot of sense. And then, maybe going back to Steve's question from before just about where the stock is trading today, curious how this impacts your capital allocation decisions. I mean, if you guys are as confident as you sound in the sustainability of the cycle, which we would agree with, I mean, would your stock be a great investment right now and even more positive signal to the market?

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

A

Well, we bought $185 million worth of stock back at $61, guys. So, I think that that gives you the answer.

John Lovallo
Analyst, UBS Securities LLC

Q

Okay. Thanks, guys.

Operator: The next question comes from Alex Barrón from Housing Research Center. Please go ahead.

Alex Barrón
Analyst, Housing Research Center LLC

Q

Yeah. Thank you, gentlemen, and great job. I wanted to focus on the trend in the gross margins this year. Clearly, in the first half, you guys are in the mid-25%. And in the back half, it looks like you'll be in the high-20% range. So, I know you're probably not going to give us 2023 guidance, but I'm more curious to see how you guys see margins unfolding as we move into next year. Is it more likely to stay at the higher level or trend back towards of kind of where margins are currently?

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

A

Yeah, Alex, I mentioned earlier that the next home sold by Toll Brothers has the highest margin we've seen in the cycle. So, I think that bodes very well for 2023.

Alex Barrón
Analyst, Housing Research Center LLC

Q

Got it. Okay. Great. And then, my other question has to do with expectations on orders. You guys, obviously, only had one negative growth quarter in October and then went back to positive this quarter. I guess related to that, in your comment about 50% of your buyers are – I think you said are move-up. I'm curious what percentage of the buyers are you guys seeing that are moving across state lines, and what percentage of your buyers are first-time buyers? I'm trying to get a sense of your mix and what's really driving the strength here.

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

A

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Sure. And just to clarify, because we are now restricting sales significantly, focusing on production and getting specs started, Q2, as I think we made very clear, will also be a quarter where sales will be down. 40% of our sales are to those moving to a different market, to migration.

Alex Barrón
Analyst, Housing Research Center LLC

Q

Got it. And what percentage are first-time guys?

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

A

30% are first-time homebuyers.

Alex Barrón
Analyst, Housing Research Center LLC

Q

Okay. Thanks and best of luck.

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

A

Thank you very much.

Operator: The next question comes from Susan Maklari from 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 Maklari
Analyst, Goldman Sachs & Co. LLC

Q

My first question is you made the comment, Doug, that the web traffic remains high and that you haven't really seen any changes in that. But just wondering if you could give us any more details in terms of what you are seeing online. Are people looking at different products? Is there any change in options that they're keeping an eye on? Are they spending more, less time? And any details around what you're seeing there?

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

A

Sure. So, we have about 9 million visitors to our website per quarter. And our foot traffic, as I mentioned, is also up, even though they all can't buy because of allocations, but they're still coming out. I'm very proud of our website. We have an amazing web team. We better have the best website in the industry being America's luxury homebuilder. I think we do. We track the amount of time they spend on the website, the stickiness, right? You get on a website and how long you want it. That's a big one.

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We also have online sales consultants now that represent every single community in every market where they engage with clients through web, texting through phone calls, not only before communities open to set up the grand opening, but even as communities are open and selling. And we call them online concierge service, and they're very, very engaged now with the web visitors. It's very easy to see how you can click the button and start to chat with the online concierge and they set it up. They tee up that client for the sales manager at the local community.

The one thing we like to see is when they click on the directions page, because that means that they're thinking about getting in their car and running after the community. But the opportunity to look at videos now, to do walk-throughs of homes, to do some design of your home, custom design, to fiddle with colors and products, all of that is available. And I'm not going to bog down on the percentages they spend on each different page, but we track it very closely.

We also changed the experience. So, different pictures come up, different pages come up, and we see what the client seems to like. And when you have 9 million visitors a quarter, you get some pretty good trends that allow us to figure out the most efficient, most optimal web experience. And so, our website is very fluid and constantly changing. Does that help?

Susan Maklari Q
Analyst, Goldman Sachs & Co. LLC

Yes. But I guess, are you seeing any changes in the stickiness to the website or what they're looking at. Anything that's been different in the last couple of weeks as we've seen rates rise relative to where we were a couple of months ago or a couple of quarters ago, or has it been consistent?

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

It's been consistent. Yeah, I don't think – I'm not aware of anything in the last month or two that has changed sort of the buyer experience on the website. We track web leads where they start on the web and ultimately go to agreement, which in today's world, I think, I'd be shocked if there's a buyer that hasn't at least spend a little bit of time on our website. But I don't – Susan, I don't think anything has changed recently because rates have gone up or for any other reason.

Susan Maklari Q
Analyst, Goldman Sachs & Co. LLC

Okay. That's helpful.

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

Okay.

Susan Maklari Q
Analyst, Goldman Sachs & Co. LLC

And then, my next question is just around, when we think about where the business is today, holistically, you focused a lot on growing the affordable luxury piece in the last several years. When you think about the business going into a rising rate environment with the affordable luxury piece of it today, which you didn't have in the past, how do you think about the mix shift that we could see the potential to sort of grow the luxury versus the affordable luxury pieces of things and any changes there that could be coming?

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

A

Yeah, I'm very happy with the progress we've made over the last three years in widening the price point, the product offering and, of course, the geographies. We're not done. There will be more affordable luxury in the mix. Right now, it's about 40% and I think it could probably get up to maybe 45%, maybe 50% over a bit of a longer term. But we're not giving up on luxury. There is still a lot of opportunity at the higher price points for us, and we're seeing that success. But as I look longer term at that mix, we're beginning to approach what I think is optimal, but we're not quite there. But we've come a long way. I'd say we're probably 80% on our way towards the long-term strategic mix that we want.

By the way, when I say 40%, that's on the dollar value. So, the actual number of homes would be higher since those homes are less expensive.

Susan Maklari
Analyst, Goldman Sachs & Co. LLC

Q

Got you. Okay. Thank you very much for all that color and good luck.

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

A

Thank you.

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

A

Thanks, Susan.

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

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

Thank you, Jason. Thanks, everyone. We really appreciate your interest and support. And happy spring, it's on its way, almost March 1. Take care. Thanks.

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

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