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Toll Brothers, Inc. (TOL)

Q3 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to Toll Brothers Third Quarter Fiscal year 2023 Conference Call. All participants will be in a 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 session, please limit yourself to one question and one follow-up. Please note, this event is being recorded. I would now like to turn the conference over to Douglas Yearley, CEO. Please go ahead.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Betsy. Good morning. Welcome and thank you all for joining us.

Before I begin, I ask you to read our 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 availability of labor and materials, inflation and many other factors beyond our control that could significantly affect future results.

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.

We had another terrific quarter and are very pleased with our fiscal third quarter results. We beat our guidance for home sales revenues, adjusted gross margin, SG&A margin and earnings. Our quarter end backlog of 7,295

homes and \$7.9 billion is strong, and our cancellations remain very well. The market for new homes is solid and we're well positioned with the right strategy in place to take advantage of it. As a result, we are raising our full-year guidance for all of our core home building metrics including deliveries, adjusted gross margin and SG&A margin. We now project earnings of between \$11.50 and \$12 per diluted share in fiscal 2023 and a return on beginning equity of approximately 22%.

In the quarter, we delivered 2,524 homes at an average price of \$1.6 million, leading to record third quarter home sales revenues of \$2.7 billion. Adjusted gross margin was 29.3% or 140 basis points above last year's third quarter, and our SG&A expense was 8.6% of home sales revenues, 170 basis points better than last year. Our margins continue to benefit from cost controls and greater leverage from higher revenues. With a significant beat on our top-line and improved margin performance, we delivered earnings per share of \$3.73, a third quarter record.

We signed 2,245 net contracts for \$2.2 billion in our third quarter, up 77% in units and 30% in dollars compared to last year's third quarter when mortgage rates were much lower in the 5% to 6% range. On a per community basis, we sold at a pace of 2.2 homes per month, compared to 1.3 last year and 2.3 last quarter. Demand was stronger than normal in our third quarter compared to the second with contracts down only 4% sequentially versus the long-term average of down 15%. Remember, the second quarter is historically stronger than the third since it is in the heart of the spring selling season. So, running almost flat Q3 to Q2 is very encouraging, particularly with rates higher in Q3 than Q2.

Demand was also solid across both geography and product lines in our third quarter and we raised price by an average of \$20,000. We saw particular strength in the Mountain and South regions, where we tend to have lower average prices. Due to the shift in mix and notwithstanding the price increase, our average sales price was flat compared to the second quarter.

In terms of cadence, we saw a relatively steady number of deposits in contracts each month of the third quarter. Actually, June was our strongest month when normally July is strongest. Often that is influenced by a sales event and this year, we ran a national sales event in June rather than July.

As we start our fourth quarter, demand remains solid. August deposits are usually down 25% to 30% versus July based on long-term historical trends as summer winds down and kids return to school. So far in August, deposits are only down 11% and both physical and web traffic is up slightly compared to July. While it is only three weeks, this is encouraging considering the increase in mortgage rates that has occurred during this period.

We attribute the solid demand for new homes, at least in part, to the well-publicized shortage of existing homes for sale. Existing homeowners are clearly reluctant to give out their low-rate mortgages. And while rising rates remain a challenge for the overall industry, they further cement a lock-in effect that has kept resell inventory at historically low levels. This has become a tailwind for homebuilders and especially the larger, well-capitalized builders who build at lower costs and are better positioned to take advantage of spec building and buying down mortgage rates.

The supply demand imbalance created by low resale inventory compounds the impact of the persistent underbuilding of homes over the past 15 years. Even before resale inventory dropped, there was a structural shortage of anywhere between 3 million and 6 million homes in this country.

In addition, demographic and migration trends continue to provide long-term support for the industry with millennials forming families and buying their first home later in life, when they have higher incomes and

accumulated wealth. Baby boomers who were either retiring or planning for it are also moving as they adjust to their new lifestyles. There also appears to be an increase in generational wealth transfer with parents helping their kids buy homes.

All of these factors combined have kept demand for new homes solid, in the face of higher rates and we are benefiting. Our strategy of increasing our supply of spec homes, which we implemented several quarters ago, has helped us meet demand while also helping to improve our cycle times. Our spec homes represented approximately 40% of our orders in the third quarter and we expect that to continue in the near term. Specs were 28% of deliveries in the third quarter.

We define a spec as any home without a buyer and has a foundation poured. We sell our specs at various stages of construction with a preference to sell before we finish the home as many of our buyers want to personalize their homes. In this way, our buyers are able to select their fixtures, appliances, flooring and other finishing options while we benefit from a faster and more efficient construction schedule.

At the third quarter end, our backlog stood at \$7.9 billion and 7,295 homes. Our cancellation rate as a percentage of backlog was 3.2% in the third quarter, down from 3.9% in the second quarter. Our industry-low cancellation rate is due to significant upfront down payments our buyers make as well as the emotional attachment they form as they personalize their homes with us.

Our buyers also tend to be more affluent. In the third quarter, 25% of our buyers paid all cash, up from 23% in the second quarter and our long-term average of 20%. Buyers who do take a mortgage make higher down payments with an average LTV of 68% in this past quarter. We are also seeing modest improvements in our cycle times as supply chains and labor constraints continue to ease and as we increase production of spec homes. We expect cycle times to continue to improve as we move forward which should further benefit our already strong cash flows.

Turning to land, at the end of our fiscal third quarter, we owned or controlled 70,200 lots, half of which were controlled and the other half owned. Excluding the 7,295 lots committed to homebuyers in our backlog, our controlled land represents 56% of total lots. Our lot count is down nearly 15% year-over-year, which reflects our selective approach to buying land and our focus on ROE and capital efficiency. Still, this land position provides us with sufficient land needed for growth in fiscal year 2024 and beyond, and allows us to continue being selective and disciplined in our approach to buying lands.

Since the start of the third quarter, we repurchased \$163 million of our common stock, bringing our year-to-date repurchase to \$265 million at an average price of \$68. We have also paid \$69 million in dividends year-to-date. We expect buybacks and dividends to remain an important part of our capital allocation priorities well into the future. As a reminder, we have planned for \$400 million of share repurchases in fiscal 2023. Assuming we buy back an additional \$144 million at the current price in the fourth quarter, which would get us to the \$400 million for the year, we will have bought back about 5% of our diluted share count at the beginning of the year.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. It was a great quarter.

We grew earnings per share by 59% and net income by 52% over last year. Home building revenue of \$2.7 billion was a third quarter record and increased 19% compared to one year ago. We delivered 2,524 homes in the

quarter, up 5% year-over-year. With the outperformance in the third quarter, we are raising our full-year deliveries guidance. We now expect to deliver between 9,500 and 9,600 homes, an increase of approximately 200 homes at the midpoint of our previous guidance.

We're also increasing our guidance for full-year average delivered price to between \$1.005 million and \$1.015 million. This translates to a home building revenue projection of approximately \$9.65 billion at the midpoint for the full year. We signed 2,245 net contracts in the third quarter for \$2.2 billion, up 77% in dollars and 30% in units over last year.

The average price of contracts signed in the quarter was approximately \$964,000 which was down 1.1% compared to our second quarter average price of \$975,000. As Doug noted, we actually raised price by an average of \$20,000 in the third quarter through base price increases and reduced incentives, which was offset by changes in mix.

Turning back to the P&L. Pre-tax income was \$553 million compared to \$366 million in the third quarter of fiscal 2022. Net income was \$414.8 million or \$3.73 per share diluted compared to \$273.5 million and \$2.35 per share diluted one year ago.

Our third quarter adjusted gross margin was 29.3%, compared to 27.9% in the third quarter of 2022 and 160 basis points better than projected. The improvement was due primarily to better cost control and fixed cost leverage on higher-than-expected home sales revenues. We're raising our full-year adjusted gross margin guidance from 27.8% to 28.5%. This 28.5% is also what we expect in our fourth quarter. Note that our fourth quarter gross margin guidance includes the impact of homes that we sold a year ago in a softer sales environment.

SG&A as a percentage of revenue was 8.6% in the third quarter, compared to 10.3% in the third quarter of last year and this is 170 basis points better than projected. In dollar terms, our SG&A expense was \$4 million lower this quarter, compared to the third quarter of fiscal year 2022 despite over \$400 million of additional home sales revenue and the impact of inflation. As we pointed out before, we've been very focused on becoming more efficient and we are now seeing the benefits flow through your results. We are projecting full year SG&A cost to be approximately 9.4% of home sales revenues which represents a 60 basis point improvement from our prior guidance. For the fourth quarter of fiscal year 2023, we expect SG&A to be approximately 8.8% of home sales revenues.

Third quarter JV, land sales and other income was \$39.4 million in the quarter or \$14.4 million above our guidance. We now expect our full-year joint venture land sales and other income to be approximately \$105 million, down from the \$125 million previously projected. This is due primarily to a challenged market for apartment building and asset sales. Our new guidance assumes we close the sale of three stabilized apartment communities that we expect to sell in this fourth quarter.

Our tax rate in the third quarter was 25%, 100 basis points better than our guidance. We expect our fourth quarter tax rate to be 26% which would bring the full year rate to approximately 25.4%. We expect interest in cost of sales will be approximately 1.5% in the fourth quarter and for the full year, as we continue to benefit from our reduced leverage. We expect community count to be approximately \$375 by fiscal year end with continued growth in fiscal year 2024.

Our weighted average share count is expected to be approximately 111 million for the full year and 109.5 million for the fourth quarter. We reiterate our guidance for approximately \$400 million of share repurchase this year, implying approximately \$150 million of buybacks in the fourth quarter. Putting this all together, we expect earn

between \$11.50 and \$12 per share in fiscal year 2023. We expect to achieve a full-year return on beginning equity of approximately 22%. We expect to bring our book value to approximately \$65 per share at yearend.

This should be the second year in a row, we earned well over \$1 billion; and this is in the period when mortgage rates doubled from slightly over 3% in November of 2021 to their current level around 7.5%. In addition, since 2020, we have generated an average of \$1.1 billion of operating cash flow per year and we expect 2023 to also exceed \$1 billion.

Turning to the balance sheet, we finished the quarter with a net debt capital ratio of 20.5%, \$1 billion in cash and cash equivalents, and \$1.8 billion available under our \$1.9 billion revolving bank credit facility, providing us with ample flexibility to both grow our business and return capital to stockholders. We also have no significant bank or senior debt maturities due until November 2025 which is fiscal year 2026 for us.

In recognition of our financial position, the solid demand for new homes and strong fundamentals underpinning the market, as well as our favorable long-term prospects, Standard & Poor's upgraded our credited ratings to investment grade this quarter. We are now rated investment grade by all three major credit rating agencies.

Now, let me turn it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Marty. Before I open it up for questions, I would like to recognize the hard work and dedication of all our great Toll Brothers employees. It is your passion for our business and commitment to our customers that will ensure our continued success.

Betsy, let's open it up for questions.

QUESTION AND ANSWER SECTION

Operator: We will now begin the question-and-answer session. As a reminder, the company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourself to one question and follow-up [Operator Instructions] The first question today comes from Rafe Jadrosich of Bank of America, please go ahead.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Hi, good morning. Thanks for taking my question.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Good morning, Rafe.

A

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Doug, I wanted to follow up on the comment you made earlier on the gross margin. You're saying the fourth quarter outlook for 28.5% includes the impact of homes that were sold last year in a softer sales environment. You have more visibility than other builders on the gross margin outlook. How do we think about how that goes going forward just given that we saw at the beginning of the year the sales environment did definitely improved?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure, so we'll give full guidance in December as we always do for 2024 and so we're not going to get ahead of ourselves right now. Marty's comment and our guidance which is about 80 basis points lower than the 29.3%, gross margin we achieved in Q3 for a 28.5% in Q4 was just a reminder that if you go back 12 months to 15 months the market had slowed dramatically, that's when – if you remember back in April of 2022, it went up dramatically; and late spring of 2022 through the summer and fall, the market softened dramatically.

A

We reminded everyone back then that we're not going to chase the bottom and we didn't. And so, an 80-basis-point drop is pretty well range bound when you think about Q4 is going to represent a bit more of the sales that occurred back in the period of time but, again, it's only 80 basis points.

Some of the sales in that slower time will continue into the beginning of 2024, but we're not going to get into the specific guidance until December on where the first quarter 2024 and the balance of the year comes out but there is some short-term pressure but the pressure is modest because we did not chase the bottom. Some of the other builders, as you know, had a pretty dramatic drop in margin to the sales that came through that period of time. And as you can see, based on our guide for the next quarter, our impact is very minimal.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Thank you. That's very helpful. And then just we've seen an improvement on the backlog conversion over the last few quarters here. How do we think about additional opportunity going forward? Where are you versus your kind of historical average and how do we think that could play out over the next few quarters?

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Well, Rafe, I think we expect to see better backlog conversion because of reduced cycle times on the to-be-built as we are in a more stable supply chain environment. We've addressed some reductions in SKUs and we're getting better at building the to-be-built, but the big piece is going to come from more specs. Specs this quarter were 28% of deliveries. We're targeting 40% of sales. We achieved that this quarter. And so, they'll be 40% of deliveries and they'll have a little bit less time in backlog, a lot less time in backlog than the to-be-built.

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

Andrew Azzi

Analyst, JPMorgan Securities LLC

Q

Hi, guys. Thanks for taking my question. This is Andrew Azzi on for Mike. I just want to get the sense of kind of regionally, market-by-market where you're seeing better ability to push price a little bit better and where it's a little bit more stubborn. Thanks.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, so, really pleased nationwide. And by the way, the \$20,000 price increase we saw in Q3 – I know the question will come up. It's about a \$10,000 dropped in incentive plus a \$10,000 increase in the base price were the sales sheet price. The incentive was about \$55,000 in Q2 and it went to \$45,000 in Q3 and then price went up by \$10,000; that's on average. And it's not everywhere; some areas are more. We still have some locations where we've gone – we're still doing [indiscernible] (00:26:40) on select communities or select inventory. The best markets and we mentioned the Mountain and the South had done the best this past quarter.

Denver, very strong. Boise, Idaho is back in a big way after taking a pause. Southern California, very strong. Atlanta New Jersey and Pennsylvania, very strong; and then all of Florida. A bit softer where we're still feeling a little bit of pain, Phoenix hasn't come back yet. It's better but it hasn't come back as we look forward to and coming back at some point, but not yet. And then on that list I'd also throw in Portland, Oregon, which is a very small market for us, but that has been a bit softer.

Andrew Azzi

Analyst, JPMorgan Securities LLC

Q

Thank you for that granularity. Appreciate it. I guess I wanted to ask about the sustainability. Obviously, this was a very nice SG&A, maybe if you can bucket out what was driving that and kind of the sustainability going forward.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, we talked now for over a year about a commitment and a drive to make Toll Brothers more efficient and we're not done but our head count is down 11% and our business is growing. And there is also lower inside and outside commissions being paid on the sales side but it is primarily overhead and we will continue to look for opportunities to do more with less. I am super proud of the steps we've taken. It will continue and those are the main drivers of it.

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

Stephen Kim

Analyst, Evercore ISI



Yeah. Thanks very much, guys. Obviously, great results. Thanks for all your comments so far. I do think it might be worth sort of thinking about what might happen if you were to see a slowdown in demand. I appreciate that in August what you shared with us certainly suggest you haven't seen that much of a negative impact from higher rates, but I think it's also fair to say we don't really know what's going to happen with rates in the next few months. And so, hypothetically, if you did see buyer demand slow, do you look back upon the strategy that you pursued last year where you let orders slow significantly rather than get aggressive with incentives? Do you look back on that and say this is – we were vindicated that that was the right thing to do and if demand slows in the months ahead, you're going to do – we should expect you to do a very similar thing that you did last year with respect to letting your orders slow but holding the line on price?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.



Yes, I'm very proud of this management team's very thoughtful decisions around our strategies to not chase the bottom. I think we ramped up our specs strategy at the right time when building costs were beginning to come down, supply chain was easing. And so, yes, we are a margin-focused builder with an understanding, of course, that capital efficiency, ROE, finally in the right way is critically important to long-term success.

But our houses are big, they're complicated, they have a lot of upgrades and features and they take a while to build. And we're not giving them away. We're not going to chase the bottom. It doesn't mean we're going to have our head in the sand and not have more incentives in a soft market than we had in a good market. I mean that's part of the conversation we've had around this modest drop in margin next quarter but, yes, I think the strategy has worked and we will continue with that strategy if your hypothetical was to prove true.

Stephen Kim

Analyst, Evercore ISI



Excellent. Thanks so much for that. It was very clear. And then taking it a step further, can we talk a little bit more about capital allocation, again, under this hypothetical scenario which hopefully doesn't actually manifest. If we do enter a softer demand patch, you've been pretty good with capital allocation in terms of dividends and buybacks and so forth. Would you likely though shift even more capital to buy backs as opposed to investing in land, particularly since you have a lot more cash actually than you did last year? And more broadly, with emerging long-only interest in the space, do you feel maybe the time is right to pursue a more asset-light strategy that might bring your year supply of owned land down to like 2 years or less as we think about the longer term positioning of the company strategy?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.



Yes. Our next debt maturity, as Marty said, is November of 2025, which is fiscal 2026. We've been generating more than \$1 billion of free cash flow for the last several years, 3 or 4 years. We have dropped our lot count by 15%, still being able with the land we control to grow community count, last year, this year, next year and beyond.

Our land teams are very good at structuring land deals to be more capital efficient. We're doing joint ventures. We're relying upon land bankers. We're getting purchase money mortgages from land sellers. We're buying improved lots just in time. Can we get it down to 2 years owned, that's hard to do when you control main-in-main. That's all I'll say. We're moving in the direction of having less owned land, but I'm not going to agree that 2 years is possible only because our business model where we buy land is a bit different.

Our land is very special, it's very unique and not every deal lines up with somebody there to feed you finished lots at the corner [indiscernible] (00:34:08) in Greenwich, Connecticut; Princeton, New Jersey; Irvine, California...

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Radnor, Pennsylvania.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Radnor, Pennsylvania. Take it home, but we are moving in that direction and you will continue to see that effort as we go forward.

A

Operator: The next question comes from Joe Ahlersmeyer with Deutsche Bank. Please go ahead.

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

Hey, good morning, everybody. Congrats on the results.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Joe.

A

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

I wanted to dig in on that point you made earlier about the higher down payment, slower loan to values. If you could maybe just hit on the psychology of this, whether you feel like your buyers are different in this regard, meaning again, for those 3 out of 4 that are taking a mortgage, a 20% down payment maybe a certain monthly payment. But are we sort of to infer that even with rates at higher levels, there is sort of cash on this buyer's balance sheet that they're using to knowingly pull forward that cash outlay and just reduce their overall debt service?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Joe, for sure, and to put it in – I know I said it, but I'll remind everybody. Long term, 20% of our clients were all cash. This quarter was 25%. And there is a good reason for it. I have the money, I'm wealthy, and I don't love a 7.5% rate so I'll put more of my own money to work and less of the bank's money to work. Our LTV has gone from 70% – this is for those that do get a mortgage – to 68%. Same reason. I'm going to put a little bit more down.

A

Our buyers are clearly wealthier. They have equity in their homes. Remember, the resale market, it's very interesting, but good, solid used homes – sorry, we like that term as new home builders – they sell and they're selling quickly and they're selling in many cases above asking price. What is sitting on the market is the old tired inventory, which actually makes it even better for us because not only is the resale market really tight, but the quality of what's sitting on the resale market is lousy.

We hope our buyers have some of the better homes that are moving faster and therefore, they may be getting a bit more equity out of their home than they have thought. So they're wealthier, they're getting a bit more equity out of the existing home, and they want to move.

I talked about it on the last call. Buying a house for people besides Marty Connor, our CFO, is not a strict financial decision. It's a family decision. It's emotional. It's moving on with your life. It's getting the kids in the better school. It's moving down as an empty nester to find the second home and all that wins, it trumps the straight financial calculation on a back of a napkin and where do they go.

They may start on a resale market; they can't find anything. We're really proud of what we do, we're really good at what we do, we have groupies, people want and aspire to get into the Toll Brothers House. We sell 10,000 a year, hope to sell 12,000 then 14,000 then 16,000, but in a scheme of the 1 million plus houses, new homes that are sold in this country in a year. We are a small fraction of it and there are plenty of buyers still out there that are in the market even at 7.5% and we're benefiting from that and that's going to continue as our brand gets better and better.

Joe Ahlersmeyer

Analyst, Deutsche Bank Securities, Inc.

Q

Yeah, makes a ton of sense. I'm glad you sort of took it that direction because I think a lot of times folks are hearing the word tailwind and maybe understanding it at least on the existing home inventory point to mean future headwind, right? I'm just curious if you see it this way. It sounds like you don't. I don't want to put words in your mouth, but maybe if you could just in your answer sort of touch on what you see as most likely scenario for existing home inventory rising and whether or not you think for Toll, this actually would represent sort of a follow-on tailwind because it means more of your prospective buyers are shaking loose from those existing homes, thanks?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. I'm not suggesting that a 7.5% market is good for the industry. It has proven to be good for the new homebuilders because the wider the spread between mortgage of the existing homeowner and today's new rate, the more lock-in effect is occurring. So, the resale market is tighter in a 7.5% rate environment than it was in a 6.5% because there's more people that are locking-in, but all day long, I will take a 5.25% rate market that frees up more existing homeowners to want to move up into our homes. Of course, I'll take that.

And will there be a bit more competition on the resale market because it is freeing up? Yes. But there'll be many more of those homeowners that want to move up where overall we will benefit and have even better results. We're just very pleased with how well we're doing considering how fast the rates have gone up, how they continue to go up and our traffic is good, our web traffic is good, and our sales are good. And is primarily driven by what I said, there are still buyers out there, they have very few options. They therefore find their way to us and they fall in love as we knew they would.

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

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Good morning. Thanks for taking my questions. Just a follow-up on kind of the LTV cash buyer dynamic. One of the interesting things about this recent rise in rates is, I think, at various points over the last year, the conventional

30-year had gone above 7, but you look at [ph] arms (00:41:11) or jumbos or FHA/VA and they had kind of lived more in the like 6.0-6.5 range. Now, all rates have kind of surpassed 7; the spreads have all compressed. Can you just talk a little about have you seen that like as people are putting that little extra money down, are you seeing people shift out of jumbos into conventionals or any [indiscernible] (00:41:37) products and part two is, given there is not as much hypothetical arm between jumping around products today, have you started to lean back into your buydowns over the last month as rates have risen?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Mike, I'll take a shot at the first half of that in terms of what we have seen buyers do. Often when rates rise, we would see them gravitate to adjustable rates. And we haven't seen that because it hasn't been attractive. The spread between adjustable and fixed just has not been substantial enough to motivate somebody to go in that direction.

We also just came through a period where jumbos were less expensive than conventionals and so in 2020, 2021, 2022, we saw buyers borrow more so they could get to the lower jumbo rate. Right now, we're seeing the inverse of that. We are seeing them increase their down payments and reduce what they're borrowing so they can stay in conventional to a greater extent.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right. With respect to buydowns and whether we've accelerated that lately, the answer is no. The buydown program doesn't work for the built-to-order business because you can't buydown a rate that's 12 months, 14 months out, but it does work well as a lead marketing headline for the spec inventory that can deliver over a 4-month period of time. So, we may advertise for a spec inventory that will take a 7.5% rate down to 5.5%, but the cost of that and let's just say it's maybe \$40,000 or \$45,000 on the \$1 million home, the total sales. It doesn't capture the buyers' attention as much as them deciding, what can I use that \$45,000 and buy finishes in the house or do something that is long-term. And I think the reason for that is, they don't look at the 7.5% rate as a 30-year rate you're stuck with. They look at it as a shorter term timeframe where they're going to refi out of it when the rate comes down and so, why use my incentive to buy a rate down that I'm not going to have for a long period of time.

That doesn't mean some don't take advantage of the buydown, but it's not like all of our spec inventory is being sold through the buydown program and that's where all the incentive is going. It's a marketing headline, it grabs attention, it starts conversation, some take it, but more flip the dollar value of the buydown into upgrades or features within the home.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Yeah. That's interesting, thanks. And maybe that's also going to differentiation for your wealthier buyer. The second question, I guess...

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right, because it's not a straight affordability issue where they have to have the 4.5% rate to get approved. It's more discretionary as to where do they want to spend the incentives.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Yeah. Yeah. Okay second question and maybe Marty, this is just a technicality or clarification on the earnings guide, \$11.50 at the lower end. If I bridge your operating metrics and account for the year-to-date charges, I think you'd get to a number that's still maybe \$0.30, give or take north of that. So is that really just hedging for your saying your guides including the three buildings that you anticipate the close? It's that simple as you're hedging in case those don't close in the fourth quarter or is there something else in the core operating metrics where you think there could be some give or take.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I think we're trying to get some rounded numbers \$11.50 to \$12 is pretty rounded I think there's some caution in there, if something doesn't go according to plan. We don't project any impairments, we don't expect any but there may be some. And so, it's as simple as that, Mike. I think you're reading much more into it than you should.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

That's helpful. Thanks.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

You're welcome.

Operator: The next question comes from Ken Zener with Seaport Research. Please go ahead.

Kenneth Zener

Analyst, Seaport Global Securities LLC

Q

Good morning, everybody.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Good morning, Ken, how are you?

Kenneth Zener

Analyst, Seaport Global Securities LLC

Q

I am doing well. Appreciate all your comments. I wonder if you could quantify – you've mentioned base pricing. Could you give us a sense this quarter, last quarter versus a longer term trend, what's your kind of base price and how much of options traditionally been a percent of your sale? And the reason I'm asking that is obviously with this liquidity from your buyers, options historically have a higher margin profile. So I'm trying to sense if you're seeing greater share of options and what the impact is historically on your gross margins? If you could give us some context. That's my first question.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. Long-term average upgrades and that includes a little lot premium...

Kenneth Zener

Analyst, Seaport Global Securities LLC

Right.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

...is 21%. Q3, it was 27%, \$236,000, that's counter-intuitive, right? With rates going up, you think maybe people are moving towards smaller homes, more affordable homes; not the case. And that goes right to the wealth of our client, and how we do it. This is their dream move and if they can afford it, they're going to reach. And so, I'm not telling you that trend is going to continue. I don't know. But those are the numbers, 21% long-term average upgrades Q3, 27%. And yes, the margin coming out of our design studios where we send the client to pick all their beautiful finishes is higher than the company's gross margin.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

And the lot premium is 100% gross margin.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And the lot premium is – correct.

A

Kenneth Zener

Analyst, Seaport Global Securities LLC

What is the – look, I guess, following up on that, what is the split between land and the physical upgrades if you would. And then the second question I really want to address is you talked about 2,200 pre-sale units last quarter. I don't know if you guys are updating us on inventory units yet, that would be useful but could you maybe talk about where we are in terms of those pre-sale starts as well as that land upgrade mix if you could? Thank you.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Gregg or...

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

So, I think we have approximately 2,400 specs under construction compared to the 2,200 you mentioned and we have around 400 [indiscernible] (00:49:48) or beyond...

A

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

Compared to approximately...

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

...compared to 350...

A

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

...ish, last quarter.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

...last quarter.

A

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

Yes.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

In terms of a breakdown of the option premium versus things in the house, what do we got there? You say it [indiscernible] (00:50:08) Gregg.

A

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

Yeah. Sure, so – yeah, Ken, so the [indiscernible] (00:50:10) prices for the quarter was, call it, [indiscernible] (00:50:14) \$870,000. So the lot premium this quarter again at a 100% gross margin with almost \$60,000 and then the option upgrades were around \$175,000. That will include both the design studio and the structural options.

A

Kenneth Zener

Analyst, Seaport Global Securities LLC

Thanks.

Q

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

Alex Barrón

Analyst, Housing Research Center LLC

Yeah. Thanks, everybody. I was hoping we could focus a little bit on your ASP trends especially in orders. I'm guessing July's quarter a year ago was a bit distorted maybe by cancellations, maybe not, maybe you can clarify that, but clearly the trend has gone from the \$1.1 million towards \$960,000. I'm just trying to understand that better. Is that due to more specs that are lower priced? Are you guys building smaller homes? Is it a more intentional thing that is going to continue or do you feel like the prices are here to stay at that level of the orders this quarter? Just some better understanding would be helpful.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

It's really a function of mix, Alex. I think, we talked about the success we've had in the mountain region and in the South where our prices are generally lower and they are in California or in the North. And so, as the business has shifted to those geographies, and as we've increased the affordable luxury line as a percentage of total, the average price mathematically comes down. It is not a function of building house type A this year at 4,000 square

A

feet and last year, it was 4,200 square feet. It's really just a function of the mix shift from a geography perspective as well as a market segment perspective.

Alex Barrón

Analyst, Housing Research Center LLC

Q

Okay. So all else being equal, you don't necessarily see these trends taking the price further down necessarily or possibly yes?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

I think they could modestly go lower, but again, it can be very lumpy quarter to quarter based on what is delivering. We are now north of 40% affordable luxury and I think we have said we're comfortable with affordable luxury getting as high as half of our business. And we also have to be careful how we define affordable luxury now because it's going up fairly dramatically in price through the COVID years and it's a very gray area and we don't market it to the public as affordable luxury. It's just an internal term to help us with how we prepare for marketing, how fancy we decorate the model homes and all the entrance features and also I think it helps the Street in understanding this move we made in price. But we're close to where I think we want to be long-term in terms of the mix between the affordable luxury, the true luxury, the empty-nester move down, et cetera. So there could be some modest drop in price but I think you've seen most of it already.

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

John Lovallo

Analyst, UBS Securities LLC

Q

Good morning, guys. Thank you for taking my question. I guess the first one is that seasonality has certainly been a little bit tricky over the past few quarters and you guys did better than normal seasonality in the most recent quarter. Just curious how you're thinking about absorption as we move into the fourth quarter given what you're seeing out there in the market today.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. It feels right now, John, like it's trending very similar to Q3. I think our comments around the three weeks of August helped explain that. We're running out of pace right now of about 24 homes sold per year per community. Last year was 25 homes sold per year per community. So it's relatively flat and that's what we're projecting. The 2010 and 2019 timeframe, again pre-COVID, we tracked it about 22 sales per community per year. So we're modestly, call it, 10% or so above that, but that's what we anticipate for the fourth quarter.

John Lovallo

Analyst, UBS Securities LLC

Q

Okay, that's helpful, and then you guys mentioned cycle times improving. Just wondering if you could help us kind of quantify where they are today maybe versus last quarter, maybe pre-COVID. And then, how much of that improvement is getting better on the to-be-built side versus just offering more spec?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, cycle times are coming down slowly. We're picking up a couple of weeks. For the next home sold, the range is about 10 months to 11 months. I think the exact number, I think is 315 days is what we project when you average out the entire company. That's obviously down dramatically from the COVID years and it's similar to what we saw previously-COVID, but we're more efficient. There's no question we've changed our operating model on the field and we're enjoying those efficiencies. The spec build as a larger percentage of our business is certainly helping because we can get the house started without the customer making all the selections.

We can build the house without the customer visiting every Sunday afternoon and coming back at as with their own little punch list. And the houses are less complicated because we're not loading them up as much as some of our clients do when they run to the design studio. So that is certainly helping. We have less SKUs, we have optimized all of our plans. We have less homes that we offer and all of that is contributing. And I do feel like it's just the beginning particularly with almost half of our business being affordable luxury which means smaller, simpler homes and this operation is focused on becoming a better production builder. There's still room to go but I am encouraged that we're down a few weeks and it's trending in an even better direction.

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, Betsy. Thank you, everyone. We appreciate all your great questions and all of your interest. We're always here, as you know, to answer any additional questions off-line. I hope everyone have a wonderful summer. Tough to believe it's over. And we'll see you through the fall and back on the call in December. Thanks again. Take care.

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

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