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# Toll Brothers, Inc. (TOL)

## Q1 2021 Earnings Call


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# MANAGEMENT DISCUSSION SECTION

**Operator**: Good morning, everyone, and welcome to the Toll Brothers First Quarter Earnings 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] Please note today's event is also being recorded.

And at this time, I'd like to turn the conference call over to Douglas Yearley, CEO. Please go ahead.

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

Thank you, Jamie. Welcome, and thank you for joining us. I hope you, your families and your colleagues are staying well. With me today are Marty Connor, Chief Financial Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Wendy Marlett, Chief Marketing Officer; and Gregg Ziegler, Senior VP and Treasurer.

Before I start, I ask you to read the statement on forward-looking information in our earnings release of last night and on our website. I caution you that many statements on this call are forward-looking based on assumptions about the economy, world events, housing and financial markets, the impact of the pandemic, and many other factors beyond our control that could significantly affect future results.

I hope you have had a chance to read our earnings release from last night. We are very pleased with our first quarter results. We achieved record first quarter order growth and exceeded our guidance on nearly every metric as we continue to benefit from a market that is playing to our strengths.


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Our business is performing at a very high level. Pre-tax income rose 93% and earnings per share rose 85% in the quarter compared to one year ago. We are increasing gross margin, leveraging SG&A with higher revenues and greater cost controls, and improving our return on equity. We are raising full fiscal year guidance across nearly all of our key metrics, and expect to deliver the most homes in our history in fiscal 2021.

Demand for new homes remains incredibly strong, and we are enjoying pricing power in nearly all of our markets. In our first quarter, net signed contracts rose 68% in dollars and 59% in units against the tough comparison in fiscal year 2020's first quarter when orders grew 31% over Q1 of fiscal 2019.

Three weeks into our second quarter, our non-binding reservation deposits are up approximately 34% overall and 38% same-store over another difficult comp to last year and despite the cold and snowy weather, impacting about one-third of our markets over the past few weeks.

Our backlog, which is up 37% in dollars and 38% in units, provides visibility into the significant gross margin expansion we project this year, especially in our third and fourth quarters as we deliver homes sold after last May. As a reminder, most of our homes take 9 to 12 months to deliver. Based on this backlog and the current market dynamics, where we continue to experience strong pricing power, we expect further gross margin expansion into fiscal year 2022.

Our results reflect a robust housing market that continues to benefit from favorable demographic trends, a very tight supply of for-sale homes, stemming from a decade of underproduction, low mortgage rates, and a renewed appreciation for the importance of home.

Home supply remains tight. According to data released by the National Association of Realtors last week, there is just 1.9 months' supply of homes on the market, a record low. According to Redfin, nearly half of all resale homes on the market are placed under contract in less than two weeks, with one-third of all resales selling above asking price.

Low mortgage rates continue to support the housing market and are driving affordability for more upscale homes and more upgrades. Interest rates have remained low for an extended period of time. The new administration and the Fed are both signaling a continuation of accommodative policy. These trends clearly favor us for the following reasons: approximately three-quarters of our buyers have a home to sell.

Rising home prices and limited supply means our buyers can sell their existing homes quickly and at appreciated values. The limited supply of existing homes is also pushing buyers frustrated with the unpredictability and frantic pace of the resale market to the more systematic process of new home sales. In addition, at Toll Brothers, our build-to-order model offers buyers the opportunity to design their homes from the ground up, allowing them to customize their homes to match their evolving lifestyles. This is the number one Toll Brothers advantage – choice, and it has never been more important to our homebuyers.

Our customers increasingly want the ability to personalize their homes, and they have the means to do it. They tend to enjoy greater job stability, have more flexibility to work from home and have wealth accumulated from rising home prices and the stock market.

This quarter, our buyers added, on average, $170,000, or approximately 26% of the base price, in lot premiums, options and upgrades. This is up from about 22% in the first quarter of fiscal year 2020 and our long-time average of 21%. Our customers are spending more as they customize their homes, which is generally accretive to our gross margin.


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We are also seeing a positive impact from demographic and migration trends. Over the past several years, we have expanded our geographic footprint and home offering. We now operate in over 50 markets in 24 states and have communities in both high-growth and a high-barrier-to-entry markets where our tremendous brand and wide range of price points enables us to serve a broad spectrum of buyers.

As the 72 million millennials transition to homeownership, our growing affordable luxury product lines are designed to appeal to these buyers. This quarter, approximately 25% of our customers were first-time buyers.

While we are eagerly looking forward to the end of this pandemic, we believe it has cemented the value of homeownership in the minds of a large portion of the US population. The pandemic has made the consumer appreciate the home more and has made work-from-home a more widespread and permanent option, especially among our consumer base.

These trends, combined with the significant undersupply of homes for sale, support long-term sustained growth in the new home market, and we are well-positioned for this growth. Our deep land position provides the foundation to grow our business. At the end of our first fiscal year, we owned or controlled approximately 67,700 lots, and we're selling from 309 communities. Even though we are selling out of communities faster than anticipated, we expect to grow community count to approximately 320 at the end of Q2 and 340 by fiscal year-end, which is an 8% full year increase from the end of fiscal year 2020.

Based on the land we already own or control, we are confident that we can continue to grow community count at a similar pace in fiscal year 2022. We continue to pursue profitable and sustainable growth, while remaining laser-focused on improving capital efficiency and return on equity.

Over the past year, we have completely revamped our land underwriting standards and are beginning to reap the benefits of this focus on capital-efficient returns. We are structuring land acquisitions much more efficiently, laying out less cash upfront by negotiating deferred payment terms with sellers and using more third-party land banking, joint venture, and option arrangements.

In short, we are controlling more land with fewer dollars, which we expect to lead to higher returns.

Our increased focus on more affordable luxury homes should also result in shortened building cycle times, improved inventory turns, lower building costs, and higher margins over time. Our expansion into geographies and price points with lower upfront land costs should also benefit return on equity long term.

We believe the combination of these positive market conditions and our relentless focus on return on equity and internal operational efficiencies will pay off in the short and long term with sustainable improved results.

In summary, we expect fiscal year 2021 to be a tremendous year for Toll Brothers, and we are laying the foundation for an even better 2022.

Now, let me turn it over to Marty.

## Martin P. Connor

*Chief Financial Officer, Toll Brothers, Inc.*

Thanks, Doug. Our business is really firing on all cylinders. Sales are strong and margins are expanding. SG&A is well-controlled and being leveraged. We are generating significant cash flow. And this quarter, we bought back


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stock, paid down debt and grew our landholdings. And we are improving our return on equity; it is our number one priority.

We expect to grow our return on beginning equity by approximately 425 basis points in fiscal year 2021, and we see further improvement in fiscal year 2022. To improve our ROE, we are buying land more efficiently, expanding our affordable luxury offerings, controlling costs, and driving towards higher gross margins.

We have streamlined and optimized much of our product offerings, which should allow us to reduce costs and cycle times, without sacrificing the high-quality customization process that distinguishes our home-buying experience. Our efforts in this area continue as we seek to further refine and streamline our products and processes.

In addition to these operational initiatives to improve our capital efficiency, we are taking steps to improve our balance sheet and reduce interest expense. In fiscal year 2020, we generated over $1 billion in net cash from operating activities, a record. In fiscal 2021, we are forecasting approximately $750 million of operating cash flow. Our strong cash generation in fiscal 2020 enabled us to balance land and builder acquisitions with returning cash to our stockholders, while prudently managing our debt. That will continue in fiscal year 2021.

In our first quarter of fiscal year 2021, we repurchased $179.4 million of our stock, or roughly 3% of outstanding shares, at an average price of approximately $44.54 per share. Since fiscal 2016, we have bought back nearly a third of our outstanding shares.

This quarter, we also repaid approximately $190 million of debt by paying down $150 million of our floating rate bank term loan and reducing purchase money mortgages on some of our owned land by about $30 million, among some other things.

We also just announced the redemption of the $250 million of 5.625% notes that were due in 2024. These notes will be retired in early March, and we expect to incur a charge for the early extinguishment of debt of approximately $33 million in our second fiscal quarter. Please remember this charge as you model our second quarter.

As a result, we expect to have retired approximately $440 million of outstanding debt in our first two quarters of fiscal year 2021 and for our net debt-to-capital ratio to be in the mid 30% range at the end of the second quarter. At fiscal year-end, we expect this ratio to be in the mid to high 20% range.

Coupled with the planned retirement of our $410 million of 5.875% notes scheduled to mature in February 2022, we expect to reduce our capitalized interest incurred by approximately $40 million annually. This should result in lower interest expense released to our income statement over time.

These adjustments and spend on our balance sheet have not impacted our ability to acquire land. In fact, we took these steps while simultaneously expanding our land position from approximately 63,200 lots at fiscal year-end 2020 to approximately 67,700 at the end of our first quarter.

We are acquiring land through more capital-efficient structures. As part of this focus, we have continued to shift more of our land buys to optioned versus owned. Optioned land was up to 46% of the total land at the end of our first quarter, versus 43% at fiscal year-end and 40% 1 year ago. Although this ratio may fluctuate from quarter-to-quarter, we are targeting a ratio of 50/50 in the near term.


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It is important to note that approximately 11,000 of our 36,400 owned lots as of January 31 were already contracted for and in our backlog or have model or unsold spec homes on them. Taking this into account, our optioned land moves from 46% to 56% of total and our supply of owned land moves from 3.6 years down to 2.6 years.

As Doug mentioned, most of our homes take 9 to 12 months to deliver, so we have strong visibility into the first half of fiscal year 2022. The pricing power we have experienced over the past six months is continuing and our backlog now stands at its highest ever in both units and dollars. This adds to our confidence that we can significantly expand margins in the back half of fiscal year 2021 and into the first half of fiscal year 2022.

And that backlog is solid. Our cancellation rate in the first quarter was 1.4% of backlog and 3.7% with this quarter's contracts. The units in backlog are supported by an average non-refundable deposit of approximately $66,000.

As Doug mentioned, we are also increasing our guidance on nearly all of our key metrics for the full fiscal year. We now expect full year deliveries of between 10,000 and 10,400 units, our highest total ever, with approximately 2,175 in the second quarter.

Delivery guidance for the second quarter reflects the slower COVID-impacted sales environment of mid-March through May 2020. This second quarter delivery guidance is consistent with guidance on our fourth quarter earnings call in December, where we guided to 40% of deliveries in the first half of fiscal year 2021 and 60% in the second half.

Our average delivered price for the full year is estimated to be between $790,000 and $810,000 per home. Average delivered price for the second quarter is expected to be between $785,000 and $805,000.

We have increased our projected adjusted gross margin for the full fiscal year by 20 basis points to 24.3%. We expect adjusted gross margin to be approximately 23.4% in the second quarter. This implies a 25% gross margin in the second half of fiscal year 2021, and we expect even higher gross margin in the first half of fiscal year 2022.

We expect full year interest and cost of sales to be approximately 2.4%; it is also what we expect in the second quarter versus 2.5% in fiscal 2020. As a result of the debt reductions I discussed earlier, we expect this interest expense to continue to decline in fiscal 2022 and beyond.

We have improved our SG&A guidance as a percentage of revenue for the full year by 30 basis points to approximately 11.9%. Our estimate for the second fiscal quarter is 13%. We continue to look for ways to optimize our cost structure to achieve permanent cost savings, including more effective marketing spend, while increasing buyer engagement. We've also reviewed our broker commission structure across all our markets and lowered overall costs.

In total, we are projecting our full-year operating margin, before impairments, to improve by 60 basis points compared to prior guidance, with further improvement expected in fiscal year 2022. We expect community count to be 320 at the end of our second quarter and 340 at fiscal year-end, with similar growth in fiscal year 2022.

Turning to other sources of income and cash flow; during the first quarter, we were able to close sales of a parking garage and two sets of retail shops associated with our Hoboken, New Jersey condo projects, sooner than originally expected, which generated cash of $79 million and a pre-tax gain of approximately $38 million. Our guidance a quarter ago anticipated one of these sales to close in Q1 and the others later in the year.


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In addition, during the quarter, we generated $75 million of cash by selling land we owned into two newly formed Toll Brothers Apartment Living joint ventures, partnerships in which we retain 25% of the equity. We have now seen the market for stabilized apartments strengthen, and we expect we will be able to complete additional asset sales this year. As a result, our full year guidance for other income, income from unconsolidated entities and land sales moves up $15 million to approximately $80 million for the full year, with approximately $7 million projected for the second quarter.

Now, let me turn the call back to Doug.

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

Thank you, Marty. Simply put, this is our time. The actions we've taken to diversify our business over the past several years have positioned us to meet the incredible demand we are seeing in every segment of the market. The growing importance of home and the desire for choice are clearly aligned with our strengths as a homebuilder. And we are working hard to take additional actions to ensure continued growth for the future.

Before we open it up to questions, I want to sincerely thank the entire Toll Brothers team and our trade partners for the extraordinary results we produced this quarter. Jamie, let's open it up for questions.

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# QUESTION AND ANSWER SECTION

**Operator**: [Operator Instructions] And our first question today comes from Stephen Kim from Evercore ISI. Please go ahead with your question.

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

Stephen?

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**Operator**: Mr. Kim? Please go ahead with your question. Is it possible your phone is on mute?

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**Stephen Kim**
*Analyst, Evercore ISI*
Q

Yes, sorry about that. Thank you. Can you hear me?

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

We can, good morning.

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**Stephen Kim**
*Analyst, Evercore ISI*
Q

Great. Good morning. Yeah, so I guess what we're hearing is all very consistent across the board and not terribly surprising. You guys are in a really great position, obviously. What's obviously on people's minds these days though is the move in rates. And you guys have a very unique niche in the market and you cater to a particular


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kind of buyer. My general sense would be that your buyer is not going to be nearly as fazed by a rise in rate if it were to transmit into the mortgage rate, as folks that may be a little bit lower down on the price point curve.

But I would love to hear you articulate what you anticipate would be the hypothetical – or the demand response, if you were to hypothetically see mortgage rates jump, let's say, 50 basis points over the course of just really rapidly, like within one month or two, how – what kind of reaction and what kind of timeframe to that reaction do you think we would see?

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

A

Sure. More than happy to answer that question. I know it's on everyone's minds. A 0.25 point move in rate on a $500,000 mortgage is $67 a month. I'm not worried. I think Jerome Powell made it clear yesterday. I think the administration has made it clear that they find homeownership to be extremely important, to be a priority. They talked about a $15,000 first-time homeowner tax credit.

I think you will continue to see relatively low rates and a move of 0.25 point, even 0.5 point; if we get to the mid-3s – if we get to the high 3s in this market, I'm just not worried. The impact to our buyer is just not that significant. There are so many other factors that now take priority over a modest tick in rate, and it's the things we talked about; the tightness of the resale market, the importance of home, the desire for choice.

Our buyers have a very low LTV, 69%; 17% of our buyers are all cash. They're benefiting from tremendous equity in their existing home. I mentioned 75% of our buyers have a home to sell. They never thought they'd have the equity they have now, when I went through those stats about the number of homes that are trading within two weeks and trading over asking price. And they're invested in markets that have performed well. They're wealthier.

And we've always seen that while – I'm not going to minimize rates, I know it's one of the levers. It's important, but I'm just not worried right now; from the messaging I hear out of the Fed, from where I think the Biden administration stands on homeownership and from the makeup of our buyer, I think we're think we're okay.

Now, if rates, as they move into the 4s or above, that could be a different conversation, certainly. But right now, with a rate that was 2.75% and has moved to 3%, Stephen, I feel good. And I think there's so many other things in our favor that we're in really good shape.

**Stephen Kim**
*Analyst, Evercore ISI*

Q

Yes. Indeed, there's always something to worry about after all. But yeah, I agree with you. Your buyer certainly seems well equipped to handle a move like that in rate.

I wanted to talk a little bit more about the – if you could segment your typical buyer for us. I'm curious as to what you're seeing in terms of – if you could just – I know we've talked about it in the past, but if you could just give us a sense for how the younger portion of your buyer pool has responded over the course of the last, let's say, 6 months versus the older portion of your buyer pool. Whether they are processing the pandemic and their life choices around housing differently in your view and in a way that you think is going to be different going forward, something that's a little bit more permanent in their thinking.

For example, the older buyer had been – we have been hearing, more interested in coming closer to the city, have amenities, access to amenities and so forth. And we have been hearing that the younger buyer, and this is in previous years, was sort of deferring making the move out to the burbs. I would imagine a lot of that's changed.


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I'd just love to hear you articulate what you're seeing at the older end versus the younger end of your buyer spectrum.

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

A

Sure. So affordable luxury, which is primarily focused on the millennials, is the fastest-growing and best-performing part of our business. Whenever you come down in price, you have more buyers. And as we have more offerings at lower prices, this is what we predicted. And we're turning those houses faster and they're generating very high ROEs and actually are exceeding our gross margin underwriting significantly.

So that buyer pool of 70 million to 75 million millennials, with I think the number one birth year being the 30-year olds, is absolutely out in the market. And we are benefiting from that, because as we've talked about, they are buying later in life than the boomers, and they are, therefore, wealthier. And so affordable luxury is their 3-Series BMW that can be their first home, and that is a tremendous growth opportunity for our company.

The move-up buyer, which, of course, is our bread and butter and what built the company, is performing very, very well. The resale markets, as we talked about, are so hot that they can sell their house quickly for more than they ever thought, giving them the opportunity to move up. The active adults – 55-and-over buyer, has been slower as they've been more careful to venture out during the pandemic because they've been a bit more at risk. As the vaccine is being offered to that demographic first, we are seeing that action pick up significantly.

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

**Alan Ratner**
*Analyst, Zelman & Associates*

Q

Hey guys. Good morning. Congrats on the great results.

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

A

Hey, Alan.

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

A

Morning.

**Alan Ratner**
*Analyst, Zelman & Associates*

Q

Thanks for all the great information and color. I'd love to first talk a little bit about – dig in a little bit more about the land underwriting strategy and standards. I think you guys kind of walked through how you're thinking about that part of the business a bit differently, and certainly makes sense.

One of the things we've heard from a lot of builders is they're tying up larger land deals. With the strength in demand, obviously, you don't want to end up with a community that you burn through in 6 months or 12 months. And others are moving further out, and that's obviously not your bread and butter. But within the context of the – more of the off balance sheet, how are you thinking about the other components of land? The absorption rate, for


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example. You're pretty close to company peak absorption, so what are you assuming on land you're buying today going forward? And gross margin, how do you think about that part of it as well, taking into account all the other variables?

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

A

Sure. So, we tightened our underwriting significantly. We look at gross margin and we look at – internally we call it an IRR, but it's obviously connected to ROE. And about a year before the pandemic, we started focusing on it. And then during the pandemic, we increased the underwriting standard even higher.

I am comforted that we continue to see good deal flow. We are just restructuring the deal terms, either with the seller where there's less cash out front and we pay over time. We're doing significantly more third-party land banking, where we assign a contract to a professional land banker, who then feeds us feeds us land back on an as-needed basis. And then we're doing joint ventures with either Wall Street private equity or with our friends in the homebuilding industry, the other builders.

So, we love the larger deals. And in the old days, we would have grabbed an entire 1,000-lot master-planned community at the corner of Main and Main, and we understand that's how we built the company and good markets rewarded us, and we now recognize that the smarter way to go is to call up one of our friends and split it. And put it off-balance sheet in a joint venture, get project level financing – and yes, we get half the lots. We get 500 instead of 1,000, but we are comfortable that they're going to have – our partner's going to have another opportunity like the one we offered them, that they will offer back to us.

And here's the good news. All the other builders want Toll Brothers to be the partner. We are the Whole Foods of the shopping center. We take the price higher and they certainly like that. And they like the way we market, and our model homes, and the action that we get.

So, we're in favor, and that really helps us with deal flow. So, it's really all of those components, the most important of which is an unrelenting, absolute focus on these new underwriting returns that I will not waiver from.

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

A

Alan, I would add that there is more capital coming into the space to land bank or land to the joint ventures we form with the other builders. And those other builders are also focused on return on equity, so are looking for chances to share, as Doug mentioned.

**Alan Ratner**
*Analyst, Zelman & Associates*

Q

No, that's very helpful. I appreciate that and I think it makes a ton of sense, especially with your price point that you would be a logical partner for a lot of companies. I guess what I'm trying to figure out though is as these new land deals that you're tying up ultimately turn into communities that you're selling homes in and delivering homes in, how is the performance of those communities going to look different based on the composition of the underwriting?

So, are these going to come in at a lower gross margin because they are more capital-efficient? Are they going to absorb at a higher pace perhaps, because – for one reason or another, based on where you're underwriting at?


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Or is it still going to deliver a pretty similar performance that the wholly-owned deals you've been doing for decades generate as well? I'm just curious if there is any notable differences that we should be thinking about.

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

A

There are not notable differences, except the ROE will be higher than some of the legacy lands. And when you land bank and you pay a land banker, 9%, 10%, 11% to carry the land that could certainly have some pressure on gross margin.

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

A

But generally, the bank financing is not much different in terms of cost than the public bond financing we've enjoyed. So, it's really just the land banking deals that show a little pressure on the gross margin.

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

A

Right. I think that the joint venture deals should not. The better terms with the land seller should not.

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

A

Should not.

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

A

The land banking deals will have some pressure. But again, we have increased the underwriting metrics to take a lot of that into account because I'm not going to compromise margin by that much.

**Alan Ratner**
*Analyst, Zelman & Associates*

Q

Do you have a rough split of the breakout of land you're tying up today, what's land banked, what's JV, what's traditional option? Just curious if you can give us rough splits there.

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

A

I don't think we are prepared to share that at this point, Alan. I think – pretty pleased with the significant progress we've made moving our optioned land up to 46%. Over the past couple of years, we've land-banked 17 deals, which is nearly $800 million of A&D, 85% of which is shifted to the land banker until we need the lots just in time. And as we look into 2021, there's another half dozen deals for $150 million, 85% of which is deferred.

**Alan Ratner**
*Analyst, Zelman & Associates*

Q

Got it. That's very helpful. I'm going to try to sneak in one quick one before I go. Marty, in the past, you've been somewhat value-conscious on the buyback, very opportunistic when the stock has gotten kind of in the lower 1 times book range, and you've stepped it up quite a bit this quarter as well. Should we expect that same approach going forward or is it going to be a little bit more programmatic now? It sounds like maybe just the return focus,


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perhaps this is something that's going to be a little bit more agnostic to valuation or am I thinking about that wrong?

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

I think it's going to be more programmatic. We hope not to have the opportunity to be opportunistic.

**Alan Ratner**
*Analyst, Zelman & Associates*
Q

Got it. Thanks a lot, guys, and good luck.

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

Thanks, Alan.

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

**Michael Dahl**
*Analyst, RBC Capital Markets LLC*
Q

Thanks for taking my question. Good stuff there. Wanted to follow up on the environment from a mortgage standpoint, but less about rate and more about the appraisal side. And just given how rapid some of the price increases have been on the new home side and the existing home side, just curious, are you starting to hear anything about appraisal issues in the field? Or do you think, by and large, appraisals, given the tightness in the market and the strength that's broad-based, have kept pace with what's happening on the price side?

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

Great question. I just asked the ops team nationwide yesterday, and we are not having any appraisal issues around the country. We do list – we get our homes offered for sale and our closings into the MLS rapidly, so the appraisers have an opportunity to see comps pretty quickly that are in the MLS. Obviously, the strength of the resale market and the increase in prices in the resale market is helping us, so, so far, we're okay.

**Michael Dahl**
*Analyst, RBC Capital Markets LLC*
Q

Okay.

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

Our mortgage group does a nice job of working through any of those sorts of issues kind of before they arise, too. It's nice to beat our own comps and to control the mortgage process.

**Michael Dahl**
*Analyst, RBC Capital Markets LLC*
Q


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Got it. And just a quick follow-up on that – and similar, in terms of your customers that have a home to sell, no appraisal issues on their end either in terms of getting the [ph] full comp (00:39:47)?

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

We have not heard that.

**Michael Dahl**
*Analyst, RBC Capital Markets LLC*
Q

Okay. My second question, just because I think potentially there might be a little sensitivity it seems to your earlier comments talking about the non-binding. And I just wanted to kind of frame that up. I mean you obviously highlighted some of the weather issues that have been widespread. But also, I think the comps throughout your fiscal second quarter, there is quite a dramatic difference in terms of the first half of the quarter versus the second half of the quarter, which was down, I think, by two-thirds year-on-year.

So, when we're thinking about [ph] sales paced (00:40:29) for the quarter, you just did kind of a three-month in fiscal 1Q, you'd normally be up sequentially in 2Q, which would imply, obviously, well north of that, of course, mid-30s range that you quoted for non-binding. Is that a fair way to think about kind of sequential pace and what you're seeing right now is maybe just a function of comp and weather?

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

Well, I'm delighted with 34% deposit growth, 37% same-store. Delighted. We have one-third of our communities on allocation, where we have effectively closed for a month and then we reopened two home sites on the first Saturday of a month and [ph] have 30 people interested and raised the price and take two by 11:00 (00:41:27) in the morning and shut her back down.

So – and we're doing that to drive price. We're doing that to make sure we have roads in front of lots. We're doing that to manage extended backlogs where we're hot. So, considering the business right now, our ability to drive price, our price was up significantly in Q4 and even more in Q1 of 2021.

We have great pricing power. We're taking advantage of it. We're managing our backlogs, and we had horrible weather for two weeks in many parts of the country where we operate. So, I am – that's one of the best metrics I've looked at is being up 37% for these past three weeks.

And remember, from mid-March until mid-May, we really got hurt by COVID last year because we didn't have those starter houses that the other builders had finished specs, where the renter can move into a finished home in a month or two for the same monthly payment.

So, just remember that the second quarter comp is very easy for us as we move forward. I know that wasn't your question, but I'm just reminding everyone of that. But in terms of your question as how I should look at the last three weeks? I'm very, very pleased.

**Michael Dahl**
*Analyst, RBC Capital Markets LLC*
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Yes, okay. That makes sense. And yes, the comps, certainly cognizant of that, that was actually more what I was asking. All that makes sense and tracks, the market can just be sensitive to any kind of deceleration versus what you just put up. But I think – I guess it still seems to be tracking towards an incredibly strong quarter. So, thanks and good luck.

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

Thank you.

**Operator**: Our next question comes from Susan Maklari from Goldman Sachs. Please go ahead with your question.

**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

Thank you, good morning, everyone.

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

Good morning, Susan.

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

Morning, Susan.

**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

My first question is just, you commented on some of the work you're doing around the cost structure, looking at the broker policy spend in there. Can you give us a little more color on that and maybe how we should be thinking about that flowing through over time?

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

Sure. So traditionally, third-party brokers represented about 60%, 65% of our sales. The client comes in with a realtor. And we pay between 2.5% and – between 2% and 3%, depending upon the local market to that third-party realtor. We have kept an eye on our competition, what the other new homebuilders are doing. We have kept an eye on the number of clients that now come in without a broker. And where appropriate – we're not a pioneer in this regard, we're certainly not going to lead, but where appropriate based upon what other builders are doing and what local market conditions are, we are lowering that third-party broker commission. And that, of course, drops right to the bottom line.

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

Sometimes that lowering is what it's applied to. It may be applied just to the base house, when in the past it was applied to the total sale price. In other cases, it may be base house plus structural options, but not interior options. So we're getting more standardized around the country in it being applied to the base house price.


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**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

Got you. Okay. And then my follow-up question is the other big topic that people have been talking about, of course, is inflation. And especially as we've seen lumber prices rising over the last couple of weeks and hitting record levels there. Can you give us some color around how you're thinking about inflation this year? I know on the last call, you mentioned you expected it to be up about 5% between labor and materials. Has that changed at all? And if so, can you just talk to some of the movements in there?

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

Sure. So lumber is up. And we expect labor to also be up a bit more modestly because labor went up fairly significantly pre-COVID. And so we really just haven't seen the labor number go up all that much more. But we are very confident that we have properly budgeted in our backlog and in our future sales for additional contingency to cover these lumber prices we're seeing, plus increases in labor and other materials. So when we talk about our gross margin in the second half of the year, and then even higher gross margin in 2022 because of the 9- to 12-month build time and the higher pricing power we've had recently, that is also building in what we think are proper contingencies to the cost side.

**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

Got you. Okay. All right. So it sounds like generally speaking, maybe a little higher than that 5% or so, but nothing that you can't offset with the pricing.

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

Yeah. Price increases have been able to offset what we've seen and what we expect to see in lumber, labor and materials.

**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

Okay. All right. Thank you, guys. Good luck.

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

Actually more than offset, Susan, sorry about that. More than offset, which is why we're showing the gross margin improvement.

**Susan Maklari**
*Analyst, Goldman Sachs & Co. LLC*
Q

Yeah, okay. That makes sense, Marty. Thanks.

**Operator**: [Operator Instructions] Our next question comes from Jade Rahmani from KBW. Please go ahead with your question.


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**Jade Rahmani**
*Analyst, Keefe, Bruyette & Woods, Inc.*
Q

Thank you very much. Are you seeing a pickup on the New York condo sales side? It seems like City Living contracts improved, but not sure how that plays out in terms of the number of joint ventures that you have versus what's wholly-owned?

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

We are. We have 33 agreements in the first quarter coming out of New York City, five buildings and that includes Jersey City, Hoboken, and Manhattan. And that's similar to the sales we had a year ago pre-COVID. So, I'm very pleased with the improvement we've seen in New York recently.

**Jade Rahmani**
*Analyst, Keefe, Bruyette & Woods, Inc.*
Q

Thank you. And then just as a follow-up, can you remind us how much capital is currently invested in each of the City Living and Apartment Living businesses and what you expect over the next 12 months? Just trying to keep track of all the joint venture announcements that have been made recently, it seems like you're continuing to make a lot of progress there.

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

Sure. In City Living, we have approximately $377 million invested, $31 million of that is in joint venture, $144 million is on-balance sheet deals that are essentially fully completed and we're just in the sellout phase, and $200 million is for land that we own for future projects.

In our Apartment Living business, it's $700 million, that's made up of around $6 million in stabilized apartment projects that actually have an unrealized gain that's somewhere between $75 million and $100 million. There's $122 million in projects that are in lease-up and we will refinance out quite a bit of that when it gets to a stabilized level. And then there's $557 million in deals where we are soliciting other joint venture partners.

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

And we believe that $700 million comes down to $400 million to $450 million as we sell stabilized properties and as we put land into joint ventures with third parties where we only keep 25% of the equity and when we refinance other properties.

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

That should happen over the next 12 to 24 months.

**Jade Rahmani**
*Analyst, Keefe, Bruyette & Woods, Inc.*
Q

Thank you very much.


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

A

You're welcome. Thank you.

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**Operator**: Our next question comes from Nishu Sood from UBS. Please go ahead with your question.

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**Nishu Sood**
*Analyst, UBS Securities LLC*

Q

Thanks; wanted to ask about the cash flow generation in 2021. After generating $1 billion last year, understandable just given the volatility, $750 million is an impressive number for 2021, especially considering how much backlog you have to build out, just how strong your demand is generally running, and obviously, the land investment is increasing as well. Can you just walk us through the kind of components there of land and inventory flow that would get you to that $750 million?

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

A

Well, I think it's really a function of the income we're generating, some of the liquidations we talked about of some of the non-core assets and then the restructuring in the way we're buying land to buy it later and just in time. So, all those things give us the confidence for that kind of projection. We're still going to spend $1.1 billion to buy land. We're still going to spend $1.1 billion to $1.2 billion to develop that land. But even after all that, we'll have a $750 million of positive cash flow.

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**Nishu Sood**
*Analyst, UBS Securities LLC*

Q

Got you, got you. And second question was just on the – Doug, you mentioned earlier, a third of your communities on allocation; obviously, a good issue to have. Given that the communities are selling out faster than expected, does that increase as the year goes on here? I mean, obviously, the sales pace continues to just run very, very strong. And how much of a governor does that become on your absorption pace as we go through the next couple of quarters?

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

A

We're just focused on bringing demand down to the right level to be able to build through it. And our backlog is up 38%. We're comfortable that that can be built to. Right now, we're at a low 30 per year average community settlement pace. This company has been in the high 30s historically. So we have the capacity to manage this growth by building it efficiently and delivering homes within the timeframe that we have represented to the client. But we certainly recognize that this 50%, 60%, 80% order growth will come down. Part of that is through allocation. Part of that is through continued price increases.

So I'm very confident that – again, the second quarter is a very easy comp. So that number is going to be distorted. That order growth will be distorted. But as we get into the back – the latter part of the year, you're going to see that order growth come down to the level that we're extremely comfortable with.

We have some new operations that have opened recently in some new markets where since the base is so low because we just opened, you can show pretty significant order growth and still build to it because it's a bit of a start-up or it's only a couple years old, and so that factors into some of these numbers.


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But overall, we keep a keen eye on it. And I think we're doing exactly the right thing with certain communities being allocated and we'll continue to focus, as we move forward, balancing price with pace. And I will mention that the community count growth we have mentioned assumes this continued strong pace. So we have the land, even with selling out faster than we had anticipated to grow this company by the numbers that we represented both in 2021 – and we have the land.

And we know we will buy more land, and we may even buy a builder or two as we've done in the past to grow 2022 more, but we have the land today to match that growth that we talked about for the balance of 2021 through 2022.

**Nishu Sood**
*Analyst, UBS Securities LLC*

Q

Got you. That's helpful. Thanks so much.

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

A

You're welcome. Thank you.

**Operator**: Our next question comes from Jack Micenko from SIG. Please go ahead with your question.

**Jack Micenko**
*Analyst, Susquehanna International Group, LLP (SIG)*

Q

Hi. Hey, guys, thanks for fitting me in; wanted – to the conversation to the inventory house side, you talk about – so let's talk about traditional Toll versus more lifestyle affordable luxury or new Toll or however you want to classify it, what's the mix of communities today? Where does that go in 2021, 2022? How much shorter cycle time is there between the traditional Toll product and more of the affordable luxury? Can we use the 25% first-time buyer as a proxy for that mix? I mean, I'd imagine you probably have some empty-nester move-downs into that product too. Just trying to – because it's part of the ROE conversation, just understanding the actual mix of inventory, where it's been, where it's headed and how to think about that.

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

A

Sure. So, Marty is going to give the mix, but I'll quickly answer your question on cycle time. Affordable luxury is running about 35 days faster, shorter cycle-time, than our traditional business, and that's getting even better as we get better at that business.

But I will also say, even with the traditional luxury business, the bigger homes, because of this optimization, rationalization of plans we've talked about and streamlining some systems in the field, even with a tighter market, we are continuing to see our cycle time come down in that business. We mentioned last quarter it was down, and it's down even more today. Marty, can you give the mix?

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

A


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Sure. So, affordable luxury this year is around 42% of communities. It should grow to 46% next year. Luxury is around 37% of communities this year and will go down to 30% next year. And active adult is at 21% this year and 24% next year.

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

And I want to point out, affordable luxury still has choice. That Toll advantage we're so proud of, of choice still applies to affordable luxury.

**Jack Micenko**
*Analyst, Susquehanna International Group, LLP (SIG)*
Q

Got it. I'll leave it there because we're at 9:30, I'll catch you offline. Thanks guys.

**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, Jack.

**Operator**: And our next question comes from Jay McCanless from Wedbush Securities. Please go ahead with your question.

**Jay McCanless**
*Analyst, Wedbush Securities, Inc.*
Q

Hey, just quickly, if lumber prices were to fall instead of continue to move higher, how quickly could you all realize some of those savings in the gross margin?

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

Very quickly.

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

I think it's six to nine months out, but we'd start to see the benefit because the houses that are in production already have the lumber contracted for.

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

Yes, I meant on the next sale.

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

Right.


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

A

So, of course, if the framers are out there – if the lumber has been bought, obviously not. But in terms of the next home sold, you're going to see it right away in the margin because that lumber doesn't hit for a number of months.

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

A

Yes. You'll see it in our projections and our budgets almost immediately. But 9 to 12 months later is when it gets through the income statement.

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

A

Of course, because it takes that long to build.

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

A

Yes.

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

A

But if the lumber has not yet been contracted for, and then we're going to obviously take advantage of it quickly. We used to contract long term for lumber to tie it up in the old days. And now we're working off of the shortest possible contracts we can so that we can be nimble and take advantage of lower pricing when it comes.

We also have our panel and truss plants that handle the Midwest, Northeast, and mid-Atlantic operations. Those plants are all on rail lines where we're buying lumber direct by the railcar out of the Pacific Northwest and out of the southern states of the US. And I think we're able to – because we're in that business, we have, I think, a little bit more visibility and the opportunity to manage those markets even better.

**Jay McCanless**
*Analyst, Wedbush Securities, Inc.*

Q

Okay, great. Thanks for fitting me in, appreciate it.

**Operator**: And ladies and gentlemen, with that, we will end today's question-and-answer session. I'd like to turn the conference call back over to management for any closing remarks.

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

Jamie, thank you very much. Thanks, everyone. We appreciate very much your interest and stay warm for those of you that are in places like Philadelphia. Have a great week. Thanks. Take care.

**Operator**: And ladies and gentlemen, with that we'll conclude today's conference call. We thank you for attending. You may now disconnect your lines.


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