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Toll Brothers, Inc. (TOL)

Q4 2022 Earnings Call

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Chief Financial Officer, Toll Brothers, Inc.

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Stephen Kim

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Alan Ratner

Analyst, Zelman & Associates

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Analyst, RBC Capital Markets LLC

MANAGEMENT DISCUSSION SECTION

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

One person who is not with us today is Bob Toll. Bob passed away in early October at the age of 81 and this is the first time in the 56 years since Toll Brothers was founded back in 1967 that we look to a New Year without him. About 500 of us gathered in November to honor Bob at our headquarters, with thousands more watching on

Zoom. The event was attended by national, business and political leaders and by the first subcontractors who worked with Bob in the 1960s, 1970s, and 1980s. Friends from the Philadelphia area he had known since childhood attended along with dozens of his family members. It was a fitting tribute to a one-of-a-kind leader and a man who helped shape this industry for decades. Although he is no longer with us, Toll Brothers will always be Bob's company. We miss him very much.

Turning to the business at hand, as Bob would insist, I'm pleased with our performance this year and extremely proud of the entire Toll Brothers team. In a year filled with supply chain disruptions, labor shortages, permitting delays, inflation, increasing mortgage rates and many other operational challenges, we delivered over 10,500 homes, the most in our history and grew homebuilding revenues by over 15% to \$9.7 billion. In the fourth quarter, we exceeded the midpoint of our deliveries and revenue guidance by 365 homes and \$368 million respectively as we focus on converting our backlog as efficiently as possible. Our fourth quarter adjusted gross margin of 29%, a 310-basis point increase compared to last year and we met our full-year guidance of 27.5%, which was a 250-basis point improvement over fiscal 2021. We reduced SG&A expense as a percentage of revenue by 110 basis points in the fourth quarter and 80 basis points for the full-year.

Before taxes, we earned \$1.7 billion in fiscal 2022. Net income was a record \$1.3 billion or \$10.90 per share diluted, resulting in a return on beginning equity of 24.3%, a 720-basis point increase over fiscal year 2021. At fiscal year-end, our book value per share stood at \$54.79 and our net debt-to-capital ratio was 23.4%. While we achieved record results in fiscal 2022, we are faced with a challenging market primarily due to the dramatic increases in mortgage rates since March.

Our net signed contracts were down 60% in units and 56% in dollars in the fourth quarter with no discernible change nearly halfway through our first quarter of 2023. However both Web and foot traffic were only down 15% in Q4 suggesting that while many potential buyers are on the sidelines, they remain interested and may just be waiting for more clarity on the direction of mortgage rates and the overall economy before they transact.

As we navigate this market, we are strategically balancing delivery of our large high-margin backlog in fiscal year 2023 which is down just 7% in value from year-end 2021 with the generation of new sales for future deliveries. We continue to assess and adjust where necessary product offerings, price and incentive levels in each of our communities, taking into account local market dynamics including elasticity of demand, the size of each communities backlog and the depth and quality of our land holdings in the market. We intend to continue making appropriate adjustments as fiscal year 2023 progresses. Fortunately, because of the size of our backlog and the strength of our projected 2023 earnings, we are able to look beyond the immediate slowdown in demand and focus on positioning the company for success in fiscal year 2024.

Let me take a moment to discuss our projected 2023 results. With the year-end backlog of 8,100 homes valued at \$8.9 billion and with a midpoint of 8,500 homes projected to be delivered, fiscal 2023 is setting up to be another solid, high-margin year. Our backlog is supported by substantial non-refundable down payments, averaging about \$83,000 per home. Through our build-to-order model, our buyers choose their specific home site, structural options and design studio finishes that match their lifestyles and their tastes. As they customize their homes, they become both financially and emotionally invested. Additionally, with approximately 20% of our buyers paying all cash and the average LTV for those who pay the mortgage at 71%, affordability is less of an issue for our buyers who tend to be wealthier with more disposable income. As a result, our backlog cancellation rate has been the lowest in the industry for decades, both through good and bad markets. During the fourth quarter, our cancellation rate as a percentage of backlog was 2.9%, just slightly above the average of 2.3% since 2010.

I want to emphasize that the right metric to focus on for our business is cancellations as a percentage of backlog. Cancellations as a percentage of current quarter sales is simply not as meaningful for a build-to-order company with a substantial backlog. The question should always be what percentage of the homes that have been sold and are being built are canceling. For us that number has consistently been the lowest in the industry.

Based on the strength of our backlog and including estimates for increased cancellations and incentivizing, we are projecting a fiscal 2023 adjusted gross margin of 27%. We expect to earn between \$8 and \$9 per share next year, which would be our second best year ever and for our book value per share to increase over \$60 at fiscal year-end 2023.

As I mentioned, because of our strong backlog and in an environment where potential buyers and many markets were on the sidelines, we chose not to aggressively chase the market down over the past six months. Also because of our build-to-order model, we did not have to take dramatically lower prices to clear a large inventory of spec homes. Instead, we have taken a more patient and balanced approach.

In recent quarters, our delivery times for to-be-build homes has been extended. In some cases, up to 16 months which was not acceptable to many buyers. Additionally, building costs have been elevated. There's a spike in inflation over the past two years. In that environment, it did not make sense to aggressively drop prices. Thankfully, quarter delivery times have started to come down as we work through our backlog and as trades free up capacity in this slower market. We are also beginning to see some building costs come down beyond just lumber which continues to steadily drop. The opportunity to build faster and at a lower cost may be here. Extended delivery times for our to-be-build homes have also resulted in the market for our spec homes being stronger than normal. With elevated spec demand and as cycle times and costs come down, we plan to thoughtfully replenish our supply of specs in select markets to generate additional deliveries in late 2023 and throughout 2024.

Community count in 2023 and 2024 will also drive results. As part of our strategy, we are timing community openings to take advantage of better seasonal opportunities. We are positioning for the spring selling season where there is typically more demand even in tougher times.

We are going back to opening our new communities in perfect white-glove condition with decorated model homes reflecting the traditional way Toll has always done it. That did not occur as often during the market frenzy that followed the pandemic where we often opened early without roads or models.

During COVID, you could sellout at the back of a station wagon with success. That is no longer the case. As an industry, we probably will not have a better sense of the depth and length of this downturn until we are further into the spring selling season in March and April and hopefully after the Federal Reserve's work is done. We recognize that if market conditions do not improve, we will need to be more aggressive with price reductions to rebuild our backlog and turn our inventory, and we'd rather be doing that when the cycle times and building costs are coming down and when more of our backlog has delivered than three or six months ago.

Turning to our land strategy, we continue to assess all transactions, whether they involve new land opportunities or takedowns under existing options using our rigorous underwriting standards that are focused on both margins and returns. Our existing attractive land portfolio allows us to be highly selective with this process and to walk away from or renegotiate deals that no longer meet our higher thresholds. Over the past three quarters, we have walked away from over 9,000 of our option lots and many additional deals have been deferred or restructured. This cost us \$12 million in forfeited options and sunk development costs, \$6 million of which was in the fourth quarter. At fiscal year-end, we owned approximately 37,700 lots and controlled about 38,300 through options.

This is a 6,000 lot or 7.5% reduction in total lots in the fourth quarter alone. We continue to target an overall mix of 60% option and 40% owned over the longer-term. Excluding the lots allocated to our backlog, 56% of total lots were controlled through options. Our existing land should allow us to grow community count 10% in fiscal year 2023. We also control enough land for further community count growth in 2024. As a reminder, we acquired much of the land for our planned fiscal year 2023 community openings prior to 2021 before land prices started inflating.

In fiscal 2022, we spent approximately \$2.2 billion on land, acquisition and development. In light of current market conditions, we expect to significantly reduce this spend in 2023 which should free up capital for other uses. With over \$3 billion of liquidity at fiscal year-end and substantial operating cash flow projected in fiscal year 2023, we are in a strong position to pay down debt, buyback stock and opportunistically acquire control of land that may become more attractively priced, all while maintaining a conservative and low leverage balance sheet.

In the fourth quarter, we repurchased \$159 million of our common stock. Since the beginning of the fiscal year, we have repurchased approximately \$543 million or 9% of our outstanding share count at the end of fiscal year 2021.

We have also paid approximately \$90 million in dividends in 2022 and we retired \$410 million of long-term debt. We expect debt reduction and share repurchases to remain an important part of our capital allocation priorities for the foreseeable future. We are planning to retire \$400 million of our 4.375% bonds in mid-January when they become callable at par and we are targeting \$100 million of share repurchases per quarter in fiscal year 2023.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. As you mentioned, we are pleased with our fourth quarter and full-year results. Our deliveries, revenue, net income and earnings per share were all quarterly and full-year records. We noticed a few analyst wrote overnight about our drop in average price per home in new contracts quarter-over-quarter. We wanted point out that this is not reflective of an actual price drop but rather the elevated average price from Q3 associated with our calculation methodology, which we described in detail last quarter.

Turning to fiscal year 2022's fourth quarter, we delivered 3,765 homes and generated revenues of \$3.6 billion, which were up 12.7% in homes and 21.4% in dollars from a year ago. The average price of homes delivered was \$951,000. Fourth quarter net income was \$640.5 million, or \$5.63 per share diluted compared to \$374.3 million and \$3.02 per share diluted a year ago. Included in net income was an after-tax net benefit of approximately \$105 million, related to the settlement of a legal claim over a 2015 gas leak in California, including an offset for the \$10 million we used to fund our new foundation. Adjusting for this net benefit, net income was \$535 million or \$4.71 per share, up 43% compared to last year's fourth quarter and still an all-time quarterly earnings record. For the full-year, we earned \$10.90 per share on a GAAP basis. Excluding the net benefits associated with the settlement and contribution, we earned \$10 per share even. As Doug mentioned, our fourth quarter adjusted gross margin was 29%, up 310 basis points compared to 25.9% in the fourth quarter of 2021.

SG&A as a percentage of revenues was 7.7% in the quarter compared to 8.8% in the same quarter one year ago. The year-over-year reduction in SG&A percentage is primarily related to the leverage from increased revenues but also to tighter cost controls as total SG&A expense only grew \$6 million on \$630 million in additional revenue, excluding the \$10 million contribution we made to our charitable foundation with proceeds of the legal settlement.

Joint venture, land sales and other income was \$152.5 million during the fourth quarter which includes an approximately \$141 million benefit related to the legal settlement. That compares to \$63.5 million in the fourth

quarter of fiscal year 2021. Excluding the settlement, we exceeded our guidance on this line item by approximately \$12 million. Write-offs totaled \$22 million in the quarter. Approximately \$6 million of this amount was related to walk away and pre-development costs on [ph] option (00:20:38) plan that we decided not to pursue. The remainder was associated with anticipated losses on the pending sales of two wholly owned City Living land parcels that we have decided not to build, instead we will sell. Both are under contract and in due diligence with buyers. We did not have any impairments on any of our traditional homebuilding land or operating communities. We continued to generate strong cash flow this year with \$978 million of cash flow from operations. We ended the fiscal year with over \$3 billion of liquidity including \$1.3 billion of cash and \$1.8 billion of available under our revolving bank credit facility. In fiscal year 2022, we invested \$2.2 billion in land acquisition and land development and our spend dropped in each quarter as the year progressed. We also returned \$633 million to shareholders through share repurchases and dividends and we reduced debt by approximately \$410 million. Our net debt-to-capital ratio was 23.4% at fiscal year-end.

As Doug mentioned, we are planning to further reduce our debt by repaying \$400 million of senior notes due in April, callable at par in mid-January. After we repaid these notes, we will have no significant maturities of our long-term debt until fiscal 2026. During the quarter, we transferred two New York market City Living projects into joint ventures as part of our capital efficiency initiatives. Results from our former City Living segment are now reported in the regions in which the projects are located, primarily the North, for this and all future reported periods. Prior periods reported in our earnings release have been reclassified and additional periods will be reclassified in our upcoming 10 K. Our forward guidance is subject to the usual caveats regarding forward-looking information.

As Doug mentioned, the 8,098 homes in backlog at fiscal year-end gives us good visibility into next year. The contracts and backlog are supported by sizable non-refundable down payments, additional promissory notes, and as Doug laid out, not to be minimized the emotional attachment our buyers have to their new, highly personalized homes. However, given the unpredictability of the current demand environment, the volatility in mortgage rates, inflationary pressures and unclear global and macroeconomic conditions, I want to stress that our forward-looking projections especially for the full-year are subject to greater uncertainty than normal.

With that said, we are projecting fiscal year 2023 first quarter deliveries of approximately 1,750 to 1,850 homes with an average delivered price between of \$950,000 and \$970,000. Consistent with normal seasonal patterns, first quarter deliveries are expected to be the low point of the year with deliveries for the full fiscal year weighted to the second-half. For full fiscal year 2023, we are projecting new home deliveries of between 8,000 and 9,000 homes with an average price between \$965,000 and \$985,000. We expect our adjusted gross margin in the first quarter of fiscal year 2023 and for the full-year to be approximately 27%. We expect interest in cost of sales to be approximately 1.6% in the first quarter and 1.5% for the full-year. This would represent a 20-basis point reduction in interest expense in cost of sales year-over-year as our leverage continues to decline. We project first quarter SG&A as a percentage of home sales revenues to be approximately 13.5% versus 13.4% one year ago. Included in first quarter SG&A is about \$12 million of our annual accelerated stock compensation expense that should not recur in the remainder of the year. It was approximately \$10 million last year. For the full-year, we project SG&A as a percentage of home sales revenues to be approximately 11.3% and expect total dollar spend to be flat with 2022. Other income, income from unconsolidated entities and land sales gross profit is expected to be approximately \$10 million in the first quarter and \$125 million for the full-year. Much of this full-year income is projected from sales of our interest in certain stabilized apartment communities developed by Toll Brothers Apartment Living in joint venture with various partners.

While the market for rental properties is currently being disrupted by the volatility in rates and economic uncertainty, we do project selling our interest in four of our joint ventures by the end of the fiscal year. We project the first quarter and full-year tax rate of approximately 26%. Our weighted average share count is expected to be

approximately 112.5 million for the first quarter and 110 million shares for the full 2023 year. This assumes we repurchased a targeted \$100 million of common stock for the quarter. Based on land we currently own or control, we expect to grow community count by 10% by the end of fiscal year 2023. Putting this altogether, that works out to be between \$8 and \$9 per share for the full-year, which would move our book value to above \$60 at fiscal year-end 2023.

With that, I will turn the call back over to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. We continue to believe that the long-term prospects of the housing market remain positive despite the recent market weakness. Demographic and migration trends continue in our favor. In addition, there continue to be a substantial shortage of homes in America that housing starts have not kept up with population growth for at least the past 15 years. We believe these fundamental drivers will support the housing market well into the future.

Before I open the call to questions, I want to again thank the entire Toll Brothers' team for another great year. We are now facing a tougher environment but we have been through this before. We are executing on the right strategy for our company and I am confident that our experienced teams will once again rise to the challenge and deliver another solid year for Toll Brothers in fiscal 2023 and beyond.

With that, let me open it up for questions. Jason, it's all yours.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Our first question comes from Michael Rehaut from JPMorgan. Please go ahead.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Thanks. Good morning everyone and thanks for taking my questions. First, I'd love to get your sense of current pricing. You guided for a 27% gross margin for fiscal 2023, which was better than we were looking for and I think speaks to the strength of the backlog and your ability to maintain some margins in the backlog. Can you try and contrast that to current pricing and the amounts of discounts that you're currently offering or incentives, trying to think about real-time gross margins and pricing in today's backdrop?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, Michael. So, our guide is 27% and I think Marty clearly laid out some caution we have in 2023 because of the current environment. If you look on paper at those 8,100 homes in backlog, the margin is higher than 27% but we are putting a cushion on that because we do know that there will be what we think of some modest elevation of cancellations. We also have some additional homes that we need to sell to hit the \$8,500 midpoint of the 2023 delivery, and so we buffered it a bit when we've come in with our guide of 27% because of the current market conditions.

In terms of where we are today, the average incentive nationwide on the next home sold is 8%. And remember that's not coming off of zero. Even in the very good times through COVID. We always had an incentive in the range of 3% to 4%, guys, is that about right?

A

Yeah. Yeah. \$25,000.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

\$25,000.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

All right. \$25,000.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

Great. No, that's very helpful. I guess secondly, you noted the SG&A for fiscal 2023 on a flat dollar spend. Can you kind of walk through the puts-and-takes of that and to the extent that revenues would be, let's say, somewhat less-than-expected, where's your ability to flex there and conversely if you're able to close more homes due to better cycle times, how should we think about the variable on the upside?

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yeah, Mike. It's good to hear from you. I think SG&A is a significant focus of ours. Unfortunately, as an operating entity, we are not immune from the effects of inflation and so we're pretty proud that we're able to keep the number flat year-over-year. Now, that is on a lower expected revenue basis, so everyday we're working towards initiatives to try and evaluate the head count and deal with some of these inflationary pressures. Our personnel are down around 6% in the last six months. Our open positions are down significantly over that same period of time. So, we are doing a nice job of holding the line on head count. We are facing an environment where we may need to turn the dial up a little bit on marketing spend and outside broker commissions. So, we are working diligently to keep SG&A as low as we possibly can.

A

Obviously more revenue will help and less revenue will hurt in terms of the leverage. We've given you our best estimate of what we think it will be for 2023.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Right. Thanks so much and good luck.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Mike.

A

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

Stephen Kim

Analyst, Evercore ISI

Q

Thanks very much guys. That was all super helpful, particularly the comment about the strategy around the spring selling season being a better time to get more aggressive on things.

I guess as a point of clarification, Bob Toll I remember talked about the spring selling season really begins in some places in January. And I guess I wanted to get some clarity on your incentive number there that you gave today about 8%. Obviously, I would assume that it is including everything, whether it be rate locks and rate buydowns and all. So, just if you could clarify is there anything that would be decremental to your gross margin that you're doing in the negotiation with the buyer that's not in that 8%? And then your order ASP, I think you said last quarter like-for-like was like \$1.15 million on average or something like that, it was like up 7%. Just wondering if this quarter's reported order ASP you think is pretty much like-for-like or if it's a different number?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, I'll answer the first part and then Marty you can jump into the second part. Stephen, the 8% is all-inclusive, whether it be price drops, incentive increases or closing costs, assistance or mortgage buydowns or anything that we can think of and that you can think of as included within that 8%.

Stephen Kim

Analyst, Evercore ISI

Q

Right.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And, yes, Bob used to talk about Super Bowl Sunday the Easter. Well, the Super Bowl is now in February, so it's a few weeks before Super Bowl Sunday and it generally extends through late April is the heart of the traditional new home selling season.

And as I mentioned, even in tougher times, we always expect more homes sold during that period than other times of the year. And so I think we strategically have made a good decision to work hard on delivering our backlog and protect it, to incentivize where there is elasticity where the market is responding to incentives, but to really wait for delivery times to come down, for building costs to start coming down and to focus on when it makes the most sense to be a bit more aggressive to go chase deals if we need to do that. And that is by each community, by each market, and based of course upon the overall bigger macro market conditions and economy.

So, that is the strategy in place. I also talked about layering in some additional spec build where appropriate in those markets that have better dynamics, and to do that at a time when we can build those specs for a bit less to set up good results for 2024. Marty?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah. I think I'm going to default to it as a like-for-like analysis with the number you quoted of \$1.150 million. But I would caution that like-for-like is very tough for us because we have differences in geographic mix, down quarter-

over-quarter and we have differences in our various segments of aff lux, active adult and luxury, so it's just like-for-like as we ever get.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Aff lux would be affordable luxury.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yes.

A

Stephen Kim

Analyst, Evercore ISI

Yeah. I got it.

Q

[indiscernible] (00:36:56)

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

We're going to get that out. I heard that yesterday [indiscernible] (00:37:02). I'm not going for that one. When you sell homes from \$300,000 to \$4 million, it's just quarter-to-quarter there can just be such differences because of geographic mix and price point mix.

A

Stephen Kim

Analyst, Evercore ISI

Great. Yeah. No, I appreciate that. Second question I have relates to the impact of mortgage rates and I know that you talked about the fact that your buyer is not as sensitive to mortgage rates in terms of affordability and yet your buyer is also fairly savvy. And mortgage rates right now are – we just had it reported at 6.4%. I mean it's already down like 70 basis points or something like that in a very short period of time. Spreads are still super-wide. I think it's entirely possible you could see a mortgage rate come down meaningfully in the next six months.

Q

And so my question is if that happens, do you think your buyer would – that you would see an improvement; a tangible, palpable improvement in demand as your buyer opportunistically takes advantage of that or do you think your buyer is basically insensitive to rates regardless if they fall or rise?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

The buyer is definitely not...

A

Stephen Kim

Analyst, Evercore ISI

Relatively insensitive. Sorry. I should say.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Okay. Yeah. So, I don't think our buyer is even relatively insensitive to rates. I think they are very smart, they're wealthy and they are definitely aware of and focused on rates. Back in August when we were altogether, I spoke of some green shoots because rates had broken below 6%.

Stephen Kim

Analyst, Evercore ISI

Yes.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And we were encouraged for a few weeks and of course that went away as rates went up into the low- to mid-7s and now they are in, call it, the mid 6s. And there are some very, very modest green shoots over the last few weeks as rates have come down but I am not ready to get sub-spec into the conversation I had with all of you in August when we felt better because it's just – we have Thanksgiving in the middle of this and it's just not enough time to understand if that move from 7.25% to 6.5% is enough to start triggering more demand.

It's December. It's not the time in the year to really comment on that and we got a bit burned by the comments that the industry made in August that didn't play out. But longer-term if these rates can break through 6% and get into the 5s, I think we're really going to be on to something and I think that applies to whether it would be first time or whether it'd be the Toll Brothers' buyer.

Our buyers are definitely wealthier. They have more equity in their home if in fact they have a home that they're going to be selling. There's more cash that they put up, there's lower leverage on the mortgage and so we have a lot of good things going for us but they are absolutely aware of and sensitive to where rates are moving.

Stephen Kim

Analyst, Evercore ISI

Yeah. That's what I think as well. Thanks very much, Doug. Just as a clarification though, can they lock the rate when they're buying like through the end – through the close?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

They can lock or we can help them lock or they can lock a rate one year out.

A

Stephen Kim

Analyst, Evercore ISI

Okay.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And that's why delivery times for us coming down is very helpful because when we were quoting 14, 16 months in some of these communities that were so backed up, it was very difficult to lock.

They can – let me explain when I say lock, they can cap a rate a year out.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And it may slow down. They can lock a rate about 110 days before closing where they can definitely lock-in a mortgage rate but you can buy a cap as far as one year out.

A

Stephen Kim

Analyst, Evercore ISI

Perfect.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

It may not be very attractive from a pricing perspective...

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

...to the consumer. But it's available.

A

Stephen Kim

Analyst, Evercore ISI

Got you.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

But I do think if a buyer wants to buy a build-to-order home from Toll, and it's a, call it, let's just say it's a 13-month delivery and they can't do anything with it right now in terms of the lock. And let's say they have a home to sell, I think there may very well be some growing confidence over the next three to six months that rates will be coming down when they can lock, call it, seven, eight, nine months out. And as those rates come down, that will make it easier for them to sell their existing home and we'll give them a lower rate on the Toll home. And I think some people already feel that way but I think that should grow as the Fed gets closer to being done with their business.

A

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

Alan Ratner

Analyst, Zelman & Associates

Hey guys, good morning, thanks for all the great details so far. First question just on the margin guidance and I certainly appreciate the disclaimer there about the unknown and the uncertainty. I was just hoping to dig in a little bit more to the trajectory you guys have. Effectively, it sounds like it incorporates margins holding pretty flat

Q

through the year with the 1Q guide identical to the full-year. Is there cost release being assumed there that might be offsetting higher incentives and pricing pressure on specs as the year unfolds there? Is it mix-driven? Why? I'm just trying to think through why margins would hold stable for the year in an environment right now that seems like pricing is under pressure?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We haven't built in cost reductions in the backlog. We continue to maintain high, what we call building cost reserves or contingencies in our underwriting. And as for-Marty, sequentially through the year?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I think the biggest factor in what would be perceived to be a declining margin environment that's offsetting that is the lumber pricing inherent in our deliveries as the year goes on. Lumber fell steadily over the last few quarters and that will be reflective and supportive of a more flat margin for 2023.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right. You had that number [indiscernible] (00:43:51). Just from the third quarter to the fourth quarter lumber dropped...

A

Yeah. \$12,000 to \$14,000 per house.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Just in one quarter there.

Alan Ratner

Analyst, Zelman & Associates

Q

Okay. So, basically as you think about that incentive number you gave earlier at 8%, it's up probably 400, 500 basis points from nine months or so ago. A lot of that is being offset, at least as 2023 progresses, through lower lumber on a per home basis?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I think if we need to point to one offsetting factor, it's the lumber.

Alan Ratner

Analyst, Zelman & Associates

Q

Got it. Okay. No, that's helpful.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We are feeling – I talked about building costs beginning to come down and cycle times beginning to come down. The frontend trades; the excavator, the foundation and concrete, the framer, window installation, siding, roofing, rough mechanicals, electric plumbing, HVAC, everything you do before you insulate a home and button it up with drywall. Those frontend trades are now fueling less action as there are less starts. And they are the ones coming forward now saying, hey, we have some capacity. And as soon as you hear the capacity word as a builder you say great and here's the new price. And so this negotiation occurring on the frontend and that will naturally move through to the backend as those finishing trades also fuel less activity.

Alan Ratner

Analyst, Zelman & Associates



Got it. No, that makes sense. Second question, this is just more a strategic question or thought. You kind of maybe alluded to this a lit bit Dough but I think it makes a lot of sense being willing to forgo some sales in the near-term with the backlog you have and kind of the seasonally slower time of the year.

Just given your build-to-order model though how long are you willing to forgo sales or kind of give up some market share recognizing it seems like you would be setting yourself up for a pretty big air pocket in 2024 unless you're willing to meaningfully increase the mix of specs in your business in 2024. Because if you're build cycle, even if it improves to 12 months, you're not going to have an opportunity for lot of sales unless you see a demand improvement through – in the spring of next year. So, how long are you willing to kind of give up that market share in the near-term and maybe not be as aggressive on pricing, or is the answer of that spec shift that you are willing to take higher?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.



Great question. Our head is not in the sand. I mentioned that we're very focused strategically on 2024 and we will pull the leverage necessary to have homes ready to be delivered in 2024 which means we will increase spec build starting in the New Year that will be ready in early, mid, the end of 2024. And it's been interesting over the last couple of quarters while we – we're about 75% build-to-order, 25% spec, and the spec business for us has been better. It's been a higher margin.

The client, one of the reasons is that they can lock a rate for a quicker delivery and they want to a little more certainty around the finances associated with buying the homes. So, our spec business has done well and we've had a bit better pricing power which gives us confidence. We're are not going 50/50 and maybe we get to 30/70, we'll have to see, but it's going to be based on certain markets and how those markets are doing and where the elasticity of demand has been. So, we will continue to keep a close eye on market conditions and adapt accordingly, and if that means not just building more spec to set up to those deliveries but being a bit more aggressive on incentives, we're going to do that. We're not going to lose market share. We have the land to grow this company. We already mentioned, 10% community count growth coming this year on the land we control. We have strategically delayed those openings as I mentioned so that they hit in a better part of the year which is the spring season and they hit. We're actively building models everywhere and holding off openings, where in COVID we would have opened them. We would have had what we called muddy shoes opening where it's hard to get on the jobsite. You got to work hard to buy a home. You're going to – it's going to be a Ritz-Carlton, white-glove, everything perfect and we're going to do it at the right time of the year. So, there's a lot of moving parts for us but because of the landholdings and the ability to grow community count and our flexibility on both spec build and pricing to market where appropriate, I'm confident our strategy is in place to have a really good 2024.

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

Paul Przybylski

Analyst, Wolfe Research LLC

Q

Thanks. It's actually Paul Przybylski. I appreciate you guys giving the order incentives at 8%. I was wondering if you could combine that with your traditional market color and where incentives may be higher or lower than that average and then also if you could give us any color on your various business segments and how orders performed in the quarter?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, Paul. I'm happy to do that. Interestingly and for the first time in some time, the East is better than the West in sales. We've talked about Smile States and everybody moving South and everybody moving West and it's simply because our West prices went up a lot more through COVID. And so you have markets like Boise and Phoenix, so it's two examples [ph] at West end (00:50:14) and the Nevada markets of Reno and Vegas as examples where we had communities where prices were up over 40% through COVID, and notwithstanding the long-term positive prospects for those markets because of the affordability, job growth, sunshine, lifestyle. They, as always happens in these cycles, the faster you go up, the first you are to come down and so the western markets are softer. They have been slower.

We have bigger backlogs at West because we were so hot out there through COVID and so we're being a bit more protective of that backlog and a bit more careful to not chase those markets down lower which is necessary because of the inelasticity. So, places like New Jersey, Philadelphia, Atlanta, Massachusetts, Michigan, Virginia and all of Florida right now are our best performers.

In terms of market segments, the active adult to empty nester, which is – it's not just 55 and over, it's the boomers that are moving down. That has been our best segment for good reasons. They pay more cash. They're less impacted by rates because they have a lot more equity in the home they raise their kids in that they've owned for 20 or 30 years and they're more affluent and they're willing to put either all or a lot more cash out to have lower mortgages.

The softest and then the other three segments which – so, there are two segments which will be affordable luxury and move-up luxury are running about the same, in City Living is doing the best which is right now New York only. We have two buildings, one in Manhattan and one in Jersey City that are crushing it in terms of sales.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

There're all in [indiscernible] (00:52:29).

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

They're all in JV. That's going to come into the other income line but we sold 80 units in Jersey City in six months at \$1 million-plus a unit and we're about to open on the Upper West Side of Manhattan what we think is significant pent-up demand. So, I haven't say that in a long time but the City Living segment is doing very, very well but it's very small and again a joint venture.

Paul Przybylski

Analyst, Wolfe Research LLC

Q

Okay. I think over the, let's call it the past 12 to 18 months, maybe even a little bit longer you probably entered maybe a half a dozen new markets. Can you maybe give us some color on where those stand and are you still committed to those markets given the new environment and now the likelihood you haven't achieved it, scale yet?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, we entered three markets in South Carolina; Charleston, Myrtle Beach and Greenville through the acquisition of one builder down there. It's fantastic. And those markets are doing very well. They were part of the Smile States. When we talked about the Smile States and how they're part of the East. And we talked about the East, so we're very, very happy with that acquisition. We had a very small acquisition in San Antonio. We have a great presence in Texas. We previously been in San Antonio. We actually had land in San Antonio for our own account when we acquired that builder. That's a small market and we're just beginning to integrate there. I would say it's too early to say but generally Texas is doing just fine.

What is else is more recent guys? Well, that's the new market. So, Spokane, Coeur d'Alene which was not a builder acquisition but was a new market on the eastern side of the state of Washington and of course Coeur d'Alene is in Idaho but it's right down the road from Spokane. That's had a very slow start.

We just had it in Long Island and at \$3 million, \$4 million we're doing really well. That's it and we opened four months ago. Not great timing but we actually have really good sales. On Nashville and new market, just too early to tell. We have a couple of urban buildings, not high-rise but mid-rise and we haven't even opened our first suburban building, so that will take a little bit of time. Tampa opened maybe three years ago. Terrific sales. We're having some production issues there that we're working through for long-term. I think we're very pleased with being in Tampa and Marty put it on the board for me and that rounds it out.

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

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Thanks for putting me in. Doug, just following up on Alan's question and Steve's earlier around just the strategy of how you evaluate the spring and not making sense to kind of push on a string and December I guess. Anymore quantification for what's kind of the trigger point on a pace basis where you just say, hey, this isn't working in the spring. The back-half of your fiscal year, you [ph] ran about at \$1.2 billion (00:55:51) per month, so is it, you just flatlined at [ph] \$1.2 billion (00:55:56) [Technical Difficulty] (00:55:58) that, hey, like we've got to drive back towards [ph] \$2 billion (00:56:01) or whatever the number is, maybe just a little operation on metrics that you're going to be looking for and what's acceptable?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, it's not one metric. We don't have a sales quota. We've never run this company top-line down but we're very mindful of the need, if we get to that point of driving more sales and I'm sorry for the vague answer but that means that we analyze every community locally, we start having meetings with the sales team, with the community team. We do a deep dive into the market comps and we start making pricing decisions accordingly. We also may have some modest shift in product offering.

Maybe you come in with a smaller house, maybe you come in with the same house but you pulled some features out of it. There's a lot of different moves that we make. It's studied weekly but it's studied very, very locally. So, I

can't tell you that if we sit at [ph] \$1.2 billion (00:57:10) sales per month and really want to be it at [ph] \$2 billion (00:57:12), we're going to start making some dramatic company-wide moves. It's going to continue to be market and community-specific and we will act accordingly as we roll through the spring season.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Understood. Okay. And then maybe from a more near-term standpoint, given some of the comments earlier in the quarter and you say you got burned by them, but it does seem like maybe you ended the quarter closer to like [ph] \$1 billion (00:57:45) a month, so when you make that comment about no discernible improvement, is that kind of relative to quarter end-pace? Is it – you were down 60% for the fourth quarter and you're just saying still down about 60%. Maybe just give us a little more on the current sales pace and what you're trying to message with that comment?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. So, the demand was pretty even between August, September and October, so our comments on November and the first – the beginning of December here are related to the entire fourth quarter. So, I wouldn't read more into it than that. To my earlier comment, we're going to continue to react to the need to incentivize where appropriate. Remember, we haven't given up on ROE and we are very focused on ROE and we will continue to focus on ROE, not just in terms of any future land buying or in terms of renegotiating of existing deals but also in terms of the need to turn inventory. And so building costs coming down, cycle time coming down, and the need to turn that inventory is front and center in our mind.

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.

Jason, thank you very much. Thanks everyone for your interest and support and great questions. We are always here to help clarify any further questions you may have. And have a wonderful, wonderful holiday season and we'll see you in the New Year. Thank you.

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

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