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Toll Brothers, Inc. (TOL)

Q3 2022 Earnings Call

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Michael Rehaut

Analyst, JPMorgan Securities LLC

Dan Oppenheim

Analyst, Credit Suisse Securities (USA) LLC

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MANAGEMENT DISCUSSION SECTION

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

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Jason. Good morning. Welcome and thank you for joining us. With me today are Marty Connor, Chief Financial Officer; Rob Parahus, President and Chief Operating Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Wendy Marlett, Chief Marketing Officer; and Gregg Ziegler, Senior VP and Treasurer.

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

In our fiscal third quarter ended July 31, we reported earnings of \$2.35 per share, up 26% compared to the third quarter of 2021 and driven by continued gross margin expansion.

Our third quarter adjusted gross margin was 27.9%, an improvement of 230 basis points compared to last year and 90 basis points better than guidance.

SG&A expense was 10.3% of homebuilding revenues which was 20 basis points better than both our guidance and last year's third quarter. We delivered 2,414 homes in the quarter at an average price of approximately \$935,000 generating \$2.3 billion in homebuilding revenues.

Although we achieved record third quarter revenues, net income and EPS and our revenues were lower than anticipated due to fewer deliveries than projected.

The shortfall resulted from the combined impact of unforeseen delays with municipal inspections, continued labor shortages, ongoing supply chain disruptions and a softer demand environment. We missed our deliveries guidance by 336 homes, most of these deliveries were concentrated in a handful of communities end markets.

For example, in California we had 200 homes that were completed at quarter end, but due to delays with city inspectors and with utility companies we simply could not get the final inspections, or the electricity needed to obtain certificates of occupancy.

The change in the demand environment also impacted Q3 deliveries. The combination of fewer spec sales, outsized lender delays, a modest uptick in cancellations, and customers taking more time to sell their existing homes, all resulted in fewer deliveries.

Due to these challenges, we are lowering our deliveries guidance. We now expect to deliver between 3,250 and 3,550 homes in our fourth quarter and between 10,000 and 10,300 homes for the full year.

Our adjusted gross margin in the third quarter at 27.9% was 90 basis points better than projected primarily due to favorable mix and effective management of cost. We ended the quarter with a solid backlog of 10,725 homes worth \$11.2 billion.

We had a total of 190 cancellations in the third quarter, equal to just 1.6% of the 11,768 homes in backlog at the beginning of the quarter and comparable to our cancellation rate of 1.2% in the first half of 2022.

For context since 2010, our average cancellation rate as a percentage of backlog has been 2.3% and yes, we think looking at cancellations as a percentage of backlog is much better than as a percentage of current orders. We have not seen any change in cancellation rates in the first few weeks of August.

We have consistently had the lowest cancellation rate in the industry for many decades, which speaks to the financial strength of our customers and our build-to-order model where buyers personalize their homes and become emotionally invested.

They make a nonrefundable down payment averaging \$80,000 so they are also financially invested as our low backlog cancellation rate in the third quarter attests, our buyers have remained committed to their new homes even in this uncertain environment.

Our backlog consist of homes sold in the very strong pricing environment of the past year, which puts us in a great position to continue to expand our gross margin in the fourth quarter and into fiscal year 2023. We project an adjusted gross margin of 29.2% for the fourth quarter and we are reaffirming our full year guidance of 27.5%.

Turning to market conditions, as our third quarter progressed, we saw a significant decline in demand as many prospective buyers stepped to the sidelines in the face of steep increases in mortgage rates, significantly higher home prices, a volatile stock market and rising inflation.

Buyer confidence was also impacted by the nonstop headlines about a softening housing market and by a general sense of uncertainty regarding the future direction of the economy. All of these factors led to a market change in psychology and buyers remain cautious through the summer months. As a result our net signed contracts were down approximately 60% in units compared to last year's historically strong third quarter.

On a dollar basis, signed contracts were down 44% year-over-year as contracts in the third quarter benefited from price increases, we had steadily applied throughout the year. For most of the third quarter we purposely did not chase buyers with incentives as we felt demand was very inelastic. Buyers were on the sidelines; they were not looking for a better deal. On average incentives in our third quarter contracts were approximately \$16,000 per home, up only \$5,000 from the average over the first half of 2022.

In more recent weeks we have seen signs of increased demand as sentiment appears to be improving and buyers are returning to the market. With higher quality traffic, we have also started to modestly increase incentives which buyers are responding to. August sales included an average incentive of about \$30,000.

In the first three weeks of August our average weekly non-bonding deposits were up 25% compared to July. We have also seen digital leads and foot traffic to our model homes increase. Our sales teams are reporting higher quality traffic and in several recently opened new communities we have seen great deposit activity. Although we are only talking about a few weeks, these are encouraging signs and we are cautiously optimistic that the housing market is settling into a more normal seasonal cadence.

Despite the near-term uncertainty we believe that many fundamental drivers that have supported the housing market in recent years remained firmly in place. These include favorable demographics with more and more millennials reaching their prime home buying years and baby boomers relocating as they embrace new lifestyles. The under supply of new homes over the past decade which has led to a large deficit and tight supply of homes for sale, migration trends driven by more workplace flexibility and a greater appreciation for home that Americans have embraced in the past few years. We believe these long-term secular trends will continue to support demand for homeownership well into the future.

In the current environment, we believe it is important – excuse me, more important than ever to remain disciplined and capital efficient in our operations and our land acquisition strategy. We're even more focused on controlling SG&A costs and becoming more efficient as we manage head count and reduce SG&A expenditures.

We have also become more conservative in our underwriting of new land deals and we'll continue to renegotiate or terminate optioned land if a project no longer meets our stricter underwriting standards.

At the end of the third quarter, we owned or controlled approximately 82,100 lots, 3,700 fewer lots than at the end of the second quarter. Approximately 51% of these lots were optioned, a decline from 53% at second quarter end due in part to our terminating options of over 3,000 lots in the quarter.

Longer-term, we continue to target an overall mix of 60% optioned and 40% owned lots. As a reminder, nearly 11,000 of our total owned lots are committed to buyers in our backlog. When you exclude these lots, 59% of our land is controlled through options.

We also remain focused on our return on equity. In the third quarter, we repurchased \$92 million of our common stock. Since the beginning of the fiscal year, we have repurchased approximately \$385 million or 5.8% of our diluted share count at the end of fiscal year 2021. We have also paid \$67 million in dividends year-to-date, and we retired \$410 million of long-term debt in our first quarter. We expect share repurchases to remain an important part of our capital allocation priorities of the foreseeable future. Additionally, we continue to employ capital-efficient strategies in our land buy.

Last week, we announced a new joint venture between our City Living division and Sculptor Real Estate to develop two luxury condominium communities in the New York City market, including the latest addition to our Provost Square development in Jersey City, where we have sold 60 units at an average price of \$1.1 million over the past three months.

We will act as a managing member and development lead, overseeing approvals, design, construction and sales. We hope to add future properties to this venture. The structure of these transactions and our strategic partnership with the seasoned team at Sculptor demonstrate our commitment to maximizing the capital efficiency of our City Living operation.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. Before we jump into the income statement, let me address the average sales price for our new signed contracts in the quarter. The average selling price attributed to contracts signed in fiscal year 2022's third quarter was \$1.3 million. It's important to point out that this average contract value was skewed higher this quarter due to the lower number of contracts we signed.

Consistent with our normal practice, our total contract value for the quarter includes both the dollar value of new contracts signed in the quarter and the dollar value of optioned sales that occurred in the quarter on homes sold in prior quarters. Remember, it's not unusual for our buyers to select finishing options a quarter or two after they sign the initial contract of sales. And while this practice typically does not skew the quoted average sale price for new orders, it did this quarter because of the much smaller denominator from fewer contracts in Q3 versus Q2 and Q1.

On a normalized basis, we estimate that the Q3 contracts' average selling price was closer to \$1.15 million, which was still up approximately 7% compared to Q2. This 7% increase was attributable to our pricing strategy throughout the previous year, including our decision not to incentivize through much of the third quarter and also by positive mix.

In our third quarter, we generated homebuilding revenues of \$2.3 billion, down 7% units and up 1% in dollars from one year ago. We also reported pre-tax income of \$366 million compared to \$303 million in the third quarter of fiscal 2021.

Net income was \$273.5 million or \$2.35 per share diluted compared to \$235 million and \$1.87 per share diluted one year ago. The increase in pre-tax and net income compared to last year was primarily driven by the significant year-over-year expansion in gross margin.

Our third quarter adjusted gross margin was 27.9% compared to 25.6% in the third quarter of 2021, and 90 basis points better than projected. As Doug mentioned, the outperformance relative to our guide was due primarily to favorable mix and effective management of costs.

We expect adjusted gross margin to be 29.2% in the fourth quarter and therefore, we continue to project 27.5% gross margin for the full year. The estimated gross margin of homes in our backlog is high, reflecting the strong and improving price environment that held through most of our third quarter. With 10,725 homes in backlog and approximately 3,400 deliveries projected for our fourth quarter at our midpoint, we have more than 7,000 homes in backlog that will form the foundation of our deliveries in fiscal year 2023. The estimated gross margin that is embedded in these deliveries is better than our projected full year 2022 margin.

SG&A as a percentage of revenue in our third quarter was 10.3% compared to 10.5% in Q3 of last year and 20 basis points better than projected despite lower than projected revenue. This was primarily due to lower than anticipated selling and marketing expense.

Third quarter joint venture land sales and other income was \$13.2 million exceeding our breakeven guidance, mostly due to gains on land sold into joint venture that we had originally projected would occur later in the year.

We had previously expected to sell several of our stabilized Apartment Living and student housing properties in our fourth quarter, which were projected to generate approximately \$50 million in income in unconsolidated entities. However, we are pushing these sales into fiscal year 2023 when we expect to see better pricing from buyers. As a result, we are lowering our 2022 full-year joint venture land sale and other income to \$60 million. Overall, our total investment in Apartment Living at the end of our fiscal third quarter was \$565 million, it consisted of \$133 million in 18 properties that were either stabilized or in lease-up where we believe we have unrealized gains of approximately \$400 million.

In addition to the \$133 million, we have \$289 million invested in 23 properties that are currently in joint venture and under construction and another \$143 million in land and projects, 28 in total, that are 100% on our balance sheet, but slated for future development and joint ventures.

This pipeline should allow us to produce a consistent series of gains from apartment sales in future years. We expect the earnings from these gains on apartment sales will continue to be a nice complement to our core homebuilding business.

Turning back to our results, impairments and write-offs were \$6.2 million in the quarter primarily reflected some due diligence cost for lost deposits on lands that we are no longer pursuing, because it doesn't meet our stricter underwriting standards. Our tax rate in the third quarter was 25.3%, 70 basis points better than projected. We now project the tax rate of approximately 24.8% for the fourth quarter and 25% for the full year. This is a slight improvement over our prior guide as we now expect approximately \$10 million in Section 45L energy tax credits that were reinstated in the recently signed Inflation Reduction Act.

We finished the quarter with a net debt to capital ratio of 34.3%, we had \$316.5 million in cash and equivalents and \$1.8 billion available under our \$1.9 billion revolving bank credit facility, which doesn't mature for over four years. This provides us with ample flexibility to both grow and return capital to our shareholders.

At quarter end our book value per share was \$48.74, we expect this to be approximately \$52.50 at fiscal year-end, let me cover the additional items in our guidance that we have not already touched on. Based on the strong

pricing in our backlog, we expect our fourth-quarter average delivered price to be between \$935,000 to and \$955,000, we have increased the full-year average to \$920,000 at the midpoint.

We expect interest in cost of sales to be approximately 1.8% of homes sales revenues in the fourth quarter and for the full year representing a 40-basis point decline compared to the full year 2021. This decline is primarily due to the retirement of higher interest rate debt over the past few years which has also decreased leverage. We expect to further reduce interest in cost of sales in fiscal year 2023.

We project SG&A as a percentage of home sales revenues to be approximately 8.7% in our fourth quarter and 10.5% for the full year. Our weighted average share count is expected to be 118.5 million for the full year. We expect the community count to be approximately 350 at fiscal year-end. We've lowered this community count projection due to the impact of entitlement delays and supply chain disruptions impacting land development and our strategy to intensely differ the opening of some communities until 2023.

Over the past two years, we are able to open communities earlier than normal without models and out-of-sale trailers or even offsite due to frenzied buyer demand. We do not see that continuing into the near future and we will shift back to our normal practice of opening communities with finished model homes and sales centers that are fully complete. Importantly, we own or control sufficient land for a significant increase in community count in fiscal year 2023.

Now let me turn it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. I want to take this opportunity to thank our incredible Toll Brothers team members who continue to work tirelessly on behalf of our clients in these unprecedented times. It is their dedication and passion for our business and make us all so excited for the future.

Jason, now let's open it up for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, we'll now begin the question-and-answer session. [Operator Instructions] And the company is planning to end the call at 9:30 AM when the market opens. During the Q&A, please limit yourself to one question and one follow-up. [Operator Instructions] Our first question comes from Alan Ratner from Zelman & Associates. Please go ahead.

Alan Ratner

Analyst, Zelman & Associates

Q

Hey, guys, good morning. Thanks for taking the questions and all the color, appreciate it. So, I guess first question just on the delivery guidance, I think you've reduced it by about 1,000 homes for the year. I'm curious if you're able to give a rough split, how much of that is kind of the supply chain challenges you guys referenced just in terms of, hey, these homes are not going to get delivered or completed before year-end like we previously thought, versus how much of that is maybe just more of a conservative view on demand for you guys had been building more specs and I assume there had been some assumption that you would sell and deliver some of those homes before year-end, how much of the reduction is just conservative around not having those homes sold or delivered in time for year-end?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks. Good question. Our model is about 80% build-to-order 20% spec and so the reduced guidance is probably Alan, around 10% to 15% due to less spec sales that we'll sell and deliver what I call in the same quarter or in a short period of time, since that's not the primary part of our business model and so the balance of let's call it 85% to 90% is primarily, I'd say two-thirds of that balance is being driven by supply chain. We've recently and the industry has recently run into these incredible problems with getting transformers from utility companies so we can get houses fired up with electricity that are completed, and getting electric meters that you put on the outside of the house and things that this is a new one for us, but it can be significant as I mentioned with the issues in California. And then the balance of the third, I'd say is a combination township issues with the inability to get inspections and to get certificates of occupancy and then some buyer delays. Right, there's more mortgage issues we have today as the mortgage rates are a bit higher and there maybe some more time for qualification. There could be longer timeframe because buyers now find it a bit harder to sell their existing home and then we've had this modest increase in cancellations which we have certainly budgeted in. I said that August cans are not up. Historically our cans are still low, but they have moved up a little bit. So when you combine all of it, very little is due to the sell and deliver spec strategy since that's not our primary business and more of it is just that bucket of items I just described which really goes to primarily production and municipality related production issues and utility company production issues but that's the bulk of it.

Alan Ratner

Analyst, Zelman & Associates

Q

Got it. Now that's really helpful. Thanks for walking through all that. Second, on the incentive environment I think, I appreciate your comments there just in terms of the inelasticity of demand through the quarter. So the easiest way to think about the incentives that you're offering in August, \$30,000, so that's roughly double from where you were before, pretty modest overall, about 1.5%, I guess in terms of, I guess a potential margin impact. When you're talking about your margin in backlog and kind of the expectation for improvement in 2023, recognizing these incentives are on new orders today, what are the conversations like in terms of your buyers in backlog? Are

they coming to you expecting a similar incentive? Are you prepared to offer that type of incentive to a buyer to keep them in backlog and ultimately how aggressive are you willing to get on the incentive front before kind of just taking the backseat and letting other builders compete in that area because traditionally you had not been very aggressive there?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, so I'm going to give you a little bit of a longer answer here because I know it's on everybody's mind. Our Q2 incentive was \$11,000 and which on \$1.1 million house, let's call it 1%. May it was \$12,000, June it was \$15,000, July it was \$22,000 and August it was \$30,000, that's \$30,000 on a \$1.1 million house we're still below 3% incentive, which historically through good times is a very low incentive. When you sell a \$1.1 million house even in a great market you tend to give the buyer \$10,000, 15,000, \$20,000, \$30,000 to spend at our design studio or to finish the basement or help them with closing costs, it's a normal incentive and we're still in that range.

We saw early on in May and June, and I talked about it a bit on the May call that we expected a slow summer. We think buyers with not only the rise in home prices but the doubling of mortgage rates, with all the chatter of that inflation, the headlines we're starting to hit about a softening market. We knew they were headed to the side lines. They were going to take the summer off and we were not going to chase those buyers down with incentives. We have \$11 billion in backlog. We're going to focus on that backlog, and it just wasn't smart business for us with our business model to do that. We didn't have finished spec inventory that we had to move out and we made the business decision, I think correctly to not chase that buyer down. It was inelastic. They were on the sidelines. They were not coming in asking what is this week's deal. They weren't negotiating.

From the 4th of July forward, we started seeing signs of better traffic. We survey our 350 sales teams around the country every week. I'm involved in calls on – for hours every Monday and we started hearing the traffic is better. They're interested, they're back. They've absorbed the new market. Summer is moving on. They're starting to think through their plans. And so we felt demand was getting a bit more elastic, meaning that buyers were interested. They knew it was more of a buyer's market than it had been, but they were at the negotiating table, interested in buying. And so we moved the incentive up modestly, and we've seen some pretty good results from that.

Does that mean we're done with incentivizing? It's community-by-community. We will continue to react to what we hear from the sales teams. And I think as summer is winding down, we're going to continue to see better traffic, higher quality traffic, but we recognize, it is certainly more of a buyer's market and we will act accordingly. So I'm not suggesting that the \$30,000 of August is – I'm not calling the bottom here. We don't know what lies ahead, but we certainly do feel better, and we will act accordingly, but we're not going to chase the incentives to a big number, and we don't think we need to do that with our business model.

With respect to the backlog, which was another one of your questions, no, we do not negotiate with the backlog. We have about \$80,000 in down payment. Do not underestimate the emotional connection our client has to the home. 80% of our buyers are custom designing the home out of the gate. It is their lot. It is their architecture. It is their structural changes, and then they go to our design studio and they spend another \$100,000, \$200,000 on all the finishes. They have become emotionally attached. It is a move-up family primarily. This is about lifestyle changes for them. The kids are moving into a new school. This is the dream house. And historically, we have not seen can rate anything close to the industry for all of those reasons. And so right now, the rates are low.

We do not negotiate with the backlog. We work with them if they need a little bit more time because there are house to sell, if we need to help them with different mortgage programs. There's lots of different things we can do

to help, but our backlog right now is secure, and we are not going back and negotiating with that backlog. They are committed for the most part and moving forward. Sorry for the long answer, but I know it's on everyone's mind.

Alan Ratner

Analyst, Zelman & Associates

Q

No. I appreciate that. Thanks again.

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

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Great. Thanks. Good morning and thanks for taking my questions.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, Mike.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

First, I – good morning, Doug. First, just wanted to hit on – to see if I can get a little more clarity on the statistic around average weekly deposits for the first three weeks of August, up 25% from July, it's a very helpful number, and obviously, around the narrative of the improvement that you're starting to see. I was just curious for context, if we could kind of get that number on a year-over-year basis, in other words, August, first three weeks average weekly deposits versus first three weeks, or roughly, let's say, August of 2021 as well as what the year-over-year was for July?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, yes – and again, it's only three weeks, so I'm not – while I say we're cautiously optimistic, I'm going to – the disclaimer here is we're talking about three weeks. It's a short window of time, but we are encouraged that deposits are up about 25% over July. When you look year-over-year, the three weeks of this July are down about 45% through the three.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

It's August.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

...through August. My apology. Thank you, Marty. The three weeks of this August are down about 45% to the same three weeks of last August. In terms of cadence, we talk about the same contracts in each month of May, June, July this year, which was about 420 agreements or orders per month. Now, when you look at last year, July was elevated significantly over last 2021's May and June, but this year, it was more level.

And so if you consider the deposits being up 25%, you just do the normal math on conversion ratios, it'd be fair to say for the next week or so until this month is over, that 420 sales that we saw in July would be about 500, if you do that math. And I'm not going to guess at all as to what September and October may hold, except that I think we are encouraged by what we see, and we've certainly loosened the strings, as I just mentioned to Alan, in terms of the incentives, and we're getting out of summer doldrums. So we're, again, have that cautious optimism as to where we're headed.

Does that answer your questions?

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Yeah. The second part of that was what was July down year-over-year, but you maybe not have that in front of you. I guess the second question I had was just kind of drilling into the comments around gross margins. Last couple of calls, you talked about an expectation for fiscal 2023 gross margins to be up over fiscal 2022. I'm not sure if I heard it slightly different, but this call so far what you've said is, the gross margins in backlog are above what you expect for the overall fiscal 2022, and you expect expansion into fiscal 2023. I was wondering if you still feel what your level of confidence is that as you look at overall fiscal 2023 that might still be up over fiscal 2022?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So I do have your answer to your July, so July 2022 deposits were down 56% over July 2021 deposits, and July 2022 agreements were down 66% against July 2021 agreements. With respect to 2023's gross margin, I think Marty laid it out in really good detail which is we have over 7,000 homes in backlog that we project will deliver in 2023. And that's just taking the math of the total backlog, what we think we'll deliver in this fourth quarter, and the balance of it, and almost the entire balance of it is projected to deliver next year. That of course is not our full year deliveries, because we still have homes we can sell in the fourth quarter, and even into early 2023 that we'll still deliver by October 31 of 2023, and that includes build-to-order's, and that of course includes many of those 20% spec homes that I talked about which is part of our strategy. It is that bucket that I can't, and I'm not prepared right now on this call to give any guidance on. We usually do that in December. That is still our intention, but our point was simply that a significant portion of 2023's deliveries are in backlog with very high margins, and so that part of the year is pretty well baked. But as for the balance that needs to be sold, we'll have to see how the market evolves, and we'll give more updates in December.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Got it. Perfect. Thanks so much. I appreciate it.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome.

Operator: The next question comes from Dan Oppenheim from Credit Suisse. Please go ahead.

Dan Oppenheim

Analyst, Credit Suisse Securities (USA) LLC

Q

Thanks very much. I was wondering in terms of the timing of community openings. You talked about delaying some openings till they're fully set. Given the tone of new communities when they come online kind of strong orders. Does that impact what you think about overall order trends for the fourth quarter of the year?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Dan, we're pretty well split with new community openings quarter by quarter. If we see the market improving or if we have a specific location where we have a lot of pent-up demand, we may go back to the COVID style, open out of the back of a station wagon on a farm field. But that is not our intention right now. This company has always white-gloved every opening, we are the Ritz-Carlton, we don't open until everything is perfect. And that's how we like to launch.

But when you get into a hot market, when you have a lot of pent-up demand, if we can get roads in, and get houses built, right, which is the other part of it. We don't want to be opening if we can't pull permits and start construction. But if all that falls together in certain locations there will certainly be exceptions to our older and now current strategy of get the entrance in, get the flower planted, get the model home perfect and off we go. But in terms of the cadence, go ahead Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Dan, we opened 20 to 25 communities in each of the first three quarters of this year and we project to open 35 to 40 communities in the fourth quarter this year. Now, while that number is down compared to what we had previously thought, it is still up significantly over the first three quarters. So, we do expect a boost in the fourth quarter from new community openings compared to the most recent quarters.

Dan Oppenheim

Analyst, Credit Suisse Securities (USA) LLC

Q

Right.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And then next year, as we mentioned in our prepared comments, we are in a great position and that we have the land controlled for significant community count growth next year. And so we will open those communities when and for the reasons I have described. But again it'll be somewhat market dependent. I am very encouraged that based on the openings that we continue to have and those that we've had over the last month, we have had significant success at the initial launch with a lot of pent-up demand and in some cases, we've sold 5, 10, 15, 20 homes in the first couple of weeks of the new launch. So, the buyers are out there, and if you have the right offerings in the right locations. We are seeing success. I mentioned 60 sales in three months in New York City at \$1.1 million. New York didn't get soft as other markets – excuse me, wasn't as high as other markets over the last couple of years as people left the cities. And so there wasn't quite a sticker shock, and the community continues to be very successful with hundreds of qualified buyers on the list that we're just working through to continue to sell theirs. So, there are certainly bright spots around the country with new openings which we're encouraged by.

Dan Oppenheim

Analyst, Credit Suisse Securities (USA) LLC

Q

Great, thanks and then just a quick follow-up, you mentioned the expectation of book value at year-end, wondering how you're thinking about allocating capital given the discount to books of relative to this environment, where you're sort of reassessing sort of putting more into land and such.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Well, Dan, we demonstrated a commitment to returning capital to shareholders through dividends that we paid this year, as well as the buybacks and we've done that as we've grown the company, I think we continue to look at balancing buybacks, we'll pay the dividends and we will continue to pursue new land deals, many of those new land purchases are from old land contracts and they still work. It is increasingly difficult for new land deals to meet our underwriting standards. So, the balance will continue to exist. We will see what opportunity set is and what the cash flow is.

Dan Oppenheim

Analyst, Credit Suisse Securities (USA) LLC

Q

Great, thank you.

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

Spencer Kaufman

Analyst, UBS

Q

Hey guys, good morning. This is actually Spencer Kaufman, on for John. Thank you for the questions. Maybe just piggybacking off of some of the comments from the last question, can you just talk about what you're seeing across your various markets, which markets are more challenged, say, which markets are hanging in better than most, and are you seeing any difference in buyer activity between your affordable luxury products and your more traditional homes?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, so the move up and the active adult have performed better than affordable luxury and I think that's because buyers are wealthier and mortgage rates aren't quite as important to them. It's not a monthly payment affordability issue as you move up in price. So, we've seen that in the past in times like this and it's proving to be the case again. The best markets for us right now are our home turf here in Philadelphia, New Jersey, Southern California, I mentioned New York City Atlanta, Denver, Dallas, the Southeast Coast of Florida, while the weakest markets which happens every cycle are those were the hottest, because when the price goes up a lot, those markets tend to take a little longer to adjust and that would include Phoenix, Austin, Texas; Boise, Idaho; and Reno, and I think again it's just an adjustment that's occurring because that the prices being higher and the affordability. Those locations also tend to be a little bit lower priced for us in many cases and so I think they probably fit a little bit more into that affordable luxury group that I mentioned where, as rates have gone up there's a bit more pressure.

Spencer Kaufman

Analyst, UBS

Q

Okay, that's helpful. I appreciate the color. And maybe can you just talk a little bit as to what would need to happen in order for you guys to see widespread impairments?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

I'm sorry I didn't.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Widespread impairment. Widespread impairment.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Oh.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yeah, I think things would have to go a lot worse than they're going right now for widespread impairments and just to kind of reiterate the breakdown of our inventory that I gave last quarter it hasn't moved too much. We have about \$9.4 billion of inventory, \$6.25 billion of that is construction in progress associated with our backlog. So there shouldn't be much concern at all about that backlog, the backlog has upper twenties gross margin to it. We've seen very low cancellation rates. So there's not too much of that. About \$2.5 billion of our inventory is owned land that also has strong margins associated with it and around \$450 million of our inventory is land deposits, and about \$80 million of that is refundable and those are for pieces of land that we have not acquired that we have under option.

A

So, with a close to 30% gross margin and a 20% operating margin from home sales, we'd have to see dramatic reductions in price for impairments to be of a concern and as you have that dramatic reduction in volume or price, you're also going to have reductions in costs. So it would have to be much more significant than a 25% or 30% decline in price to trigger any impairments and those impairments would be associated with those smaller buckets of inventory, land and deposits, not so much associated with our homes under construction and backlog.

Spencer Kaufman

Analyst, UBS

Thanks, Marty.

Q

Operator: The next question comes from Matthew Bouley from Barclays. Please go ahead.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Hey, good morning, everyone thanks for taking the questions and for all the detail. Just a question on ASP and pricing power in light of all these communities you've got coming online, I appreciate that detail you gave around the order ASP in Q3 so that's helpful, but as we think about these future community openings, I mean how should we think about sort of the opening price points and margins on that, is that an area that you might flex a little bit given current market conditions? Thank you.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Again, it's very, very specific to the location and the interest. We hope not to flex, we like the 30% gross margin but if we have to flex, we will but that decision is made very locally but we are very confident and comfortable with the underwriting we have in place now for these new openings that continue to show significant outsized gross margins. So again it'll – we go through a pricing analysis before every community opens and that analysis is based on detailed market comps, the number of VIP buyers we have that are interested in buying and we do a full analysis and make decisions on where to open and of course we have a keen eye on what those returns are when we do that but right now, I'm very comfortable that the communities we have slated to open over the next year will perform well.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Got it, no thank you for that and then just second one on I guess sales pace and underwritings presumably if the sales pace at this level is maybe a little bit less than what you had sort of underwrote to in the past, I guess the question is kind of how do you balance the – where you want inventory turns to get or to be versus just that potential pressure on returns? Or is the result of all that simply just reducing your acquisition of owned land? Like, how do you kind of balance those points? Thank you.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Well, we're – as we've been talking about for a few years, it's not just profit margin, it's also capital efficiency and ROE. So we are absolutely balancing price with pace. The fact that we had a very slow quarter does not mean that our head is in the sand and we're not going to sell because we're trying to maintain a margin. We recognize there is a balance. And the reason we didn't have sales is what I described, that in May, June and into the early summer, the buyers were on the sidelines, and we didn't think it was about price unless you wanted to really drop the price to go grab those few buyers that might have been out there.

As that is changing, I think we will do a good job of balancing the incentive necessary to drive an absorption that will still have an eye on ROE and being capital efficient. So, we recognize the need, and as part of our strategy, to focus on driving strong margins, but also being capital efficient and having good returns.

With respect to the land, our underwriting has gotten even tighter. I talked on the last call that we are now up to 60% combined gross margin, and what we call internally IRR, so if you had a 30% gross margin, you needed a 30% IRR, that's now 65%. And on top of it being 65%, we are building in today's sales paces and today's pricing. So that's a bit of a double whammy because sales pace is down a bit and price with more incentives is down a bit, and on top of that, you've layered in the higher threshold that you have to hit.

So, we're going to continue to be disciplined. And by the way, when we exit due diligence, we're doing that new analysis and deciding whether we want to go forward, and we're going back to land sellers to renegotiate. And if they don't come around, then we will drop deals. The only reason our optioned lots went up modestly this – went down modestly this quarter is because we dropped 3,000 optioned lots because they no longer penciled with our tighter underwriting. And the quarter before that, we dropped a couple thousand lots for the same reason.

So, I'm very happy with the discipline we're bringing to land buying. We have a great land portfolio that allows us to grow community count significantly next year and we'll continue operating this way into the future.

Matthew Bouley

Analyst, Barclays Capital, Inc.

Q

Great. Thanks for all the detail, Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

You're very welcome. Thank you.

A

Operator: The next question comes from Susan Maklari from Goldman Sachs. Please go ahead.

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Thank you. Good morning, everyone.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Good morning.

A

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

My first question is, can you just talk a little bit about the supply chain and build times? And as we are seeing the market shift, how you're thinking about the forward trajectory for the construction cycles as we go into the back half of this year and then into next year?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. So right now, our cycle time from agreement is about 13 months on average, 380 days. That's not pure construction because the frontend – takes a while for the client to pick their finishes, their options, and for us to get a building permit. So the actual build cycle time is not that full 380 days. Affordable luxury is about 60 days less than that because the houses are smaller and a bit simpler. It is up. It continues to climb. Right now, the stress I mentioned is on things we took for granted like transformer boxes. You guys have all seen those green boxes in the front yard of houses that generally handle about 4 to 6 homes on a street. You have to put a transformer down, which gives the electricity to those 4 to 6 houses. And utility companies have apparently run out of them at the moment or are having a hard time finding them. And this is just the whack-a-mole issues that the industry is dealing with.

A

Finished trades right now, our houses are a bit more complicated when you get beyond Toll Brothers – when you get beyond drywall with the Toll Brothers home, there's a lot more that goes into those finishes with tile and millwork and cabinets and things like that. And on the finish end right now, we're feeling a bit of pressure with delay – with trades. And so I think that's pushed out. If you look at drywall to delivery, we've added a couple of weeks from what we used to have.

So that's the latest issue that we are addressing. There are some encouraging signs that I have for next year when it comes to supply chain. We are on the phone regularly with our biggest suppliers and I'm hearing some encouraging words in that regard, but we're not building that into any of the projections we're making internally or to you.

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Q

Okay, that's helpful. And then following up, understanding that spec is only about 20% of the business, but can you talk about where you are in terms of the spec inventory and how you're thinking about adding to that as we go forward?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. We're in really good shape right now with spec. We have about 1,800 what we define as spec, which means the homes have a footing, which is a foundation in the ground. So spec doesn't mean it's finished. Internally, it means we have started a home. We have poured concrete. We have a footing in place for a home that has not yet sold. And sometimes we'll sell that house at frame because now you can get it in five months instead of getting it in 13 months, and sometimes, we'll hold that house until finishes. So we are in very good shape, now not every one of those specs that sits at footing is moving forward right now. We're making some decisions to move houses forward on a full cadence and we're making decisions in other locations to sit and wait to see where the market goes.

Behind those 1,800 we have many houses that have permits in place and in some municipality that can be a couple of months to get a permit. So we will decide when that permit gets a go, which means we're going to move forward with footings and build the house. But last year our spec inventory was depleted because the market was so hot. We were selling very rapidly, and I am very happy now to have the 1,800 at footing or beyond with more permit behind that, because now we can pull levers in certain locations based on market conditions as when and how quickly we move forward with those.

But overall the strategy we think is the right one at our price point to be 80% build-to-order which is what most people want with Toll Brothers but then 20% are houses that are available in a quicker turn time and many of these specs you're allowed to have finishes because we'll put the house on the market let's say a drywall, so you can still pick your kitchen cabinet, your countertops, your flooring which our clients want.

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Q

Okay, that's very helpful color. Thank you.

Operator: We have time for one last question that's from Mike Dahl from RBC Capital Markets. Please go ahead.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Thanks for squeezing me in last minute.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Hey, Mike.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Just quick, Doug on the, just going back to the deposits and the orders in August, when you make that comment on kind of all else equal tracking to about 500 orders in August, if you just look at deposit trends, how high the conversion rates from deposits and contracts been trending the last couple of months and what does that comment kind of imply for conversion in order to hit say a 500 order number in August?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So we're trending at about 70% of our deposits convert to agreement and it's consistent with what we had over the last couple of quarters. In fact I just – Gregg Ziegler just sent me a piece of paper that says our five-year average conversion ratio is 71% and we're right on that now, last month, last quarter, last year.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay, that's very helpful and then my follow-up just given what you articulated around the gold cycle or the order to close cycle, what are you finding is the right balance of incentives for your buyer right now and I don't mean magnitude but I mean kind of price, because it's easier to see versus something that's quicker, close a financing incentive where you could have visibility on kind of cost of locking and buying down the rate that could be effective but...

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

...with your [ph] long (01:01:30) cycle, what's making the most sense for you or your buyers?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right, so mortgage buy down would be number one. We have programs that allow our clients to get the mortgage rate under 5 now that may not apply to long-term, we can't lock a sub 5 for 13 months but there are opportunities as they have with closer to delivery that we have that opportunity closing cost, always help people. We recently ran a kitchen and bath weekend where there were upgrades to your kitchen and your master bathroom which is that's where people want to put the money. You can get second and third level cabinets, countertops, appliances, and that's always very effective.

We move the incentives around regularly, this weekend it's finished basement, next weekend it's \$25,000 credit at our beautiful design studio, when you do you go do finish it. So there's not one thing but in today's market where rates are on everybody's mind that's generally where the incentive starts, but we do have 20% cash buyers, right. So there is an example right away, we're going to give money at the design studio or we're going to lure them into the kitchen and bath sales of that. So, it's constantly moving on purpose, we do not touch the price sheet and we try – the local teams have the authority to try to adapt their incentives that they've been given to what they think will be most effective for their clients.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. Thanks, Doug, really helpful.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

You're very welcome. Thank you.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Okay, Jason, I think the time is up. And thanks everyone. So, Jason, and thanks everyone for your interest and your support. We are always here to answer any questions you may have offline and have a wonderful end of summer. Take care.

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

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