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Toll Brothers, Inc. (TOL)

Q2 2022 Earnings Call

CORPORATE PARTICIPANTS

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Chairman & Chief Executive Officer, Toll Brothers, Inc.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

OTHER PARTICIPANTS

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Analyst, UBS Securities LLC

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Charles Perron-Piche

Analyst, Goldman Sachs & Co. LLC

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Alan Ratner

Analyst, Zelman & Associates

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Analyst, Raymond James & Associates, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Toll Brothers second 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 that 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 for joining us. With me today are Marty Connor, Chief Financial Officer; Rob Parahus, President and Chief Operating Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Wendy Marlett, Chief Marketing Officer; and Gregg Ziegler, Senior VP and Treasurer.

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

We're very pleased with our second quarter performance as we met or exceeded our guidance on all key metrics. We delivered a record 2,407 homes in the second quarter at an average price of approximately \$908,000 resulting in record home sales revenue of \$2.2 billion. This was an increase of 19% compared to last year's second quarter revenue. Our teams did a great job delivering homes and what continues to be a very challenging production environment. Adjusted gross margin of 26.1% in the quarter improved 170 basis points compared to

last year's second quarter and was 60 basis points better than guidance. SG&A expense at 11.1% of homebuilding revenues was 80 basis points better than both last year's second quarter and our guidance. Driven by significant revenue growth and expanding margins, we generated earnings per share of \$1.85, up 83% compared to last year.

At second quarter-end our backlog stood at a record \$11.7 billion and 11,768 homes. Based on the strong pricing and margin embedded in our backlog and with approximately half of our backlog schedule for delivery in fiscal year 2023, we expect our fiscal year 2023 adjusted gross margin to be better than fiscal year 2022's.

Sales in our second quarter were our highest quarter ever as demand remained strong across all of our buyer segments and geographies. We signed 2,874 net contracts for \$3.1 billion, up 1.2% in dollars over 2021's extremely strong second quarter when orders were up 97% in dollars compared to Q2 of 2020. Our quarterly sales pace was consistent with the 8.8 contracts per community that we projected for Q2 on our earnings call back in February. While demand is still solid, over the past month, it has moderated from the unprecedented pace of the past two years as buyers adapt the higher mortgage rates and other macroeconomic conditions.

The substantial rise in home prices, the steep increase in mortgage rates since January, inflation concerns and stock market volatility are all having an impact on buyer sentiment. And we anticipate that some buyers may remain cautious through a seasonally slower summer months.

As a reminder, in the second quarter we limited sales to catch up on construction. We are continuing this strategy in the third quarter. With the combination of restricting sales, the normal summer slowdown and a more cautious buyer, we expect our Q3 contracts to be lower than Q2, which is what normally occurred in pre-COVID.

Despite the recent moderation, the housing market remained healthy. Even over the past month, we have continued to raise prices and in limited number of communities and we are running successful best and final sealed-bid processes in about 15% of our communities.

The many fundamental drivers that has supported the housing market in recent years remained firmly in place. These include favorable demographics, with 150 million millennials and baby boomers experiencing life events that are driving home demand. The supply and demand imbalance resulting from over a decade of underproduction, tight resale inventories, migration trends driven by more flexibility in the workplace, and then overall greater appreciation for homes and in particular new homes.

In addition, the for-sale housing market is benefiting from an ongoing and significant increases in rents for single and multifamily dwellings. We believe these trends will continue to support housing demand in the long-term.

Turning specifically to our customers, we believe they are generally better insulated from affordability concern. They tend to have higher incomes and net-worth and many have benefited from significant price appreciation in their existing homes. Approximately 20% of our customers pay all cash and those who do take a mortgage, average approximately 70% loan-to-value. Importantly our buyers utilizing jumbo loans are benefiting from a rate that remains 0.75 point lower than the conforming rate.

As our industry continues to be challenged by supply chain disruptions, labor shortages and municipal delays, we have revised our full year deliveries guidance. We now expect full year deliveries to be between 11,000 and 11,500 homes, a reduction of about 375 homes at the midpoint. However, we have increased our average delivered price guidance by \$15,000 per home to reflect the strong pricing in our backlog. As a result, we expect

full year 2022 homebuilding revenues of approximately \$10.1 billion at the midpoint of our guidance or 20% growth compared to fiscal year 2021.

We remain committed to a disciplined and capital efficient land acquisition strategy. At the end of our fiscal second quarter we owned or controlled 85,800 lots, of which 53% were controlled and 47% were owned. Nearly 12,000 of these lots are already committed to homebuyers in our backlog. Excluding these, our controlled land represents 61% of lots. This land position, much of which was contracted for pre-pandemic, provides us with sufficient land needed for significant growth well into the future.

Therefore, we can be very selective as we evaluate new land deals and apply our more rigorous underwriting standards that incorporate higher gross margin and IRR thresholds, higher contingencies for land development and construction costs and more conservative assumptions related to sales paces.

We also remain focused on improving our return on equity. In the second quarter, we repurchased \$106.5 million of our common stock and another \$16 million so far in our third quarter. Since the beginning of the fiscal year, we have repurchased about \$308 million or 4.6% of our year-end share count. We have also paid \$44 million in dividends year-to-date and we retired \$410 million of long-term debt in our first quarter.

In March, our board approved an 18% increase in our quarterly dividend and just last week refreshed our share repurchase authorization to 20 million shares or nearly \$900 million based on current prices. These actions reflect our confidence in the business and our commitment to delivering returns to our shareholders.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks Doug. In our second quarter, we delivered 2,407 homes and generated homebuilding revenues of \$2.2 billion, up 6% in units and 19% in dollars from one year ago. The average selling price of our 2,874 signed contracts in fiscal year 2022's second quarter was \$1.75 million, up nearly \$200,000 compared to last year's second quarter and up \$53,000 over Q1. Our second quarter pre-tax income was \$296 million compared to \$170 million in the second quarter of fiscal 2021. Net income was \$221 million or \$1.85 per share diluted compared to \$128 million, and \$1.01 per share diluted one year ago.

Our second quarter adjusted gross margin was 26.1% compared to 24.4% in the second quarter of 2021. And 60 basis points better than we had projected. The improvement was due primarily to price reflecting the strong demand environment over the last year.

We continue to project an adjusted gross margin of approximately 27.5% for the full year. We expect the adjusted gross margin for our third quarter of fiscal year 2022 to be 27% which implies an adjusted gross margin in excess of 29% in our fourth quarter.

As Doug mentioned, we believe our fiscal year 2023 adjusted gross margin will be even better than this year's. This is due primarily to the composition of our backlog and the pricing power we've experienced over the past year. Approximately half of our existing backlog of 11,768 homes are projected to be delivered in fiscal year 2023 and this backlog is solid.

Our cancellation rates have consistently been the lowest in the industry for many decades which speaks to the financial strength of our customers and our build-to-order model which allows our buyers to personalize their

homes becoming emotionally invested in those homes. They are also financially invested, as they make a nonrefundable deposit averaging \$75,000 plus they benefit from any home price appreciation between contract signing and ultimate delivery, which has been significant. As a result, we've had just 114 cancellations in our backlog of over 11,000 homes in the second quarter or about 1%. We haven't seen any significant changes in May.

Let me quickly address any concerns that rising mortgage rates may have on future cancellation rates. First of all, keep in mind that 20% of our buyers pay all-cash. Fluctuations in interest rates should have no impact on these buyers.

We've also pressure tested the balance of our backlog. We estimate that if the 30-year conforming rate were to increase to 6%, less than 10% of our backlog would have to consider an ARM, provide a higher down payment or additional source of income or consider other alternatives such as buying down rates with upfront points.

As our low cancellation rates in the second quarter attest, our buyers have remained committed to their new homes even with the rapid increase in interest rates. And remember that homes in our older backlog, which were contracted for when rates were lower, have enjoyed significant price appreciation which means these buyers have greater motivation to close and we have lesser risk if they don't.

Turning back to our results, SG&A as a percentage of revenue was 11.1% in the second quarter compared to 11.9% in Q2 of last year and this was 80 basis points better than we projected. The improvement was driven primarily by revenue growth and lower sales and marketing spend.

Second quarter joint venture land sales and other income was \$12 million exceeding our guidance of \$5 million due primarily to a gain from the bulk sale of home security monitoring accounts. Impairments and write-offs were \$2.2 million in the quarter reflecting some cost on land deals that we're no longer pursuing.

Our tax rate in the quarter was 25.4%. We finished the quarter with a net debt to capital ratio of 33.1% with \$535 million in cash and equivalents and with \$1.8 billion available under our \$1.9 billion revolving credit – bank credit facility. This all provides us with ample flexibility to both grow and return capital to our shareholders. At quarter end, our book value per share was \$46.51. Based on the midpoint of our guidance and supported by our solid backlog, we expect this to be approximately \$53 per share at fiscal year-end.

Turning to guidance, we are projecting fiscal year 2022 third quarter deliveries of 2,750 homes with an average price between \$895,000, and \$915,000. As Doug mentioned, continued supply chain and labor constraints and municipal delays are impacting production. As a result, we have reduced our full year delivery guidance by approximately 375 homes to between 11,000, and 11,500. But based on the pricing and our backlog, we have increased our projected average delivered price to between \$890,000 and \$910,000, a \$15,000 of increase from prior guidance.

We expect interest and cost of sales to be approximately 2% in the third quarter and for the full year as we continue to benefit from our reduced leverage.

We project third quarter SG&A as a percentage of home sales revenues to be approximately 10.5%. For the full year, we project SG&A as a percent of homes sales revenues to be approximately 10.4%, a modest 10-basis-point improvement from our prior guidance. We expect community count to be approximately 325 at the end of the third quarter to 370 by fiscal year-end. We've lowered our full-year community count protection slightly due to municipal delays and supply chain disruptions impacting land development.

Other income, income from unconsolidated entities, and land sales gross profit is expected to be break even for the third quarter, but is now expected to be approximately \$110 million for the full year, an increase of \$10 million over our prior guidance. Our guidance for the fourth quarter is therefore \$68 million primarily from the sale of certain Apartment Living assets.

We project a tax rate of approximately 26% for the third quarter and 25.7% for the year. Our weighted average share count is expected to be 119 million shares for the full year and 117.5 million for the third quarter. Based on all these factors, we continue to project approximately \$10 per share in full year earnings per share and a return on beginning equity of approximately 23%.

Now, Doug back to you.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. Before I open it up for questions, I'd like to thank all of our Toll employees for their hard work this quarter, their commitment to providing our customers an extraordinary home buying experience is key to our success.

Jason, let me open it up to questions.

QUESTION AND ANSWER SECTION

Operator: Thank you, we'll now begin the question-and-answer session. As a reminder, the company is planning to end the call at 9:30 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 John Lovallo from UBS. Please go ahead.

John Lovallo

Analyst, UBS Securities LLC

Q

Good morning guys and thank you for taking my questions. Maybe a couple higher level ones today. The first one, we're in the middle of probably the largest generational wealth transfer of \$68 trillion from boomers to millennials and Gen X over the next 15 years, which is probably the greatest, we've ever seen. Just curious if you have any sense of how many of your buyers are receiving assistance on down payments and what kind of benefit that could be for the industry going forward?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure John. As we told you in the past and it's pretty consistent this quarter, about 30% of our buyers are first-time homebuyers. Now they're buying more expensive homes than what I'd call a traditional starter home. As we talked about, it's our 3 Series BMW. And I don't – I can't give you that answer. I'm not sure whether our mortgage team, Marty can get that, I'm not sure we know exactly where it comes from. But I'm with you. I think mom and dad are helping out a lot. I bought my first house in 27 and my amazing father and mother guaranteed my mortgage because, I didn't have – I was just getting out of law school. So, I couldn't – the mortgage company maybe was impressed by my diploma on the wall but not by my income. So, that's absolutely happening and I'll have the team offline to see if we can put – get you some more specifics on that. Now our buyer is, as I said, a bit

more affluent even in that first home. So they probably have a little bit more saved up. And so, maybe they don't have to lean on mom and dad quite as much but I'm with you, I think there's quite a bit of that that is happening.

John Lovallo

Analyst, UBS Securities LLC

Yeah. That's...

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yeah John, and I think it also helps buyers continue to qualify in a rising rate environment, either through a gift from mom and dad for a higher down payment...

A

John Lovallo

Analyst, UBS Securities LLC

Right.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

...which, I don't know that we have those stats, but we can try and dig them up.

A

John Lovallo

Analyst, UBS Securities LLC

Yeah, that's helpful. I mean, the National Association of REALTORS said it's about 25% of millennials that claim that they have received assistance. So I may think it's pretty powerful.

Q

Next question is, is there a risk in your mind that the industry is just securing too much land on option and that could be sort of inflating prices and if demand does moderate at some point, do you think that builders may not take some of these lots down which can put pressure – downward pressure on land prices. And I guess along with that, is it fair to assume that if this did happen that there's a pretty good cushion between where we are and where impairments could occur?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. No, I don't think the builders are too focused on optioning land. I think driving return on equity is the right way to run our companies. I think whether it would be land banking, whether it would be joint ventures with other builders, whether it would be terms with your underlying land seller that allows you to pay over time. I think all of that is very smart business. So is it have a modest impact on margin, yes, because if you're paying a land banker, 9% to carry land and feed it back to you when you need it or if you're paying a land seller effectively an interest or a terms payment and not buy all of his land or her land now but buy it over time, that can have a modest impact on the margin. But I think it is very smart business to treat that modest reduction in margin for less risk the liability if needed to pivot and move away from some land that you don't own outright, but you simply control and to drive that capital efficiency that ROE up. So, I don't think the move towards ROE is – I think it's here to stay, and I think it's here to stay through good cycles and bad cycles and I'm very comfortable with how Toll Brothers is approaching it and I'm very impressed by how disciplined the industry has become over the last few years and how we're all buying land.

A

John Lovallo

Analyst, UBS Securities LLC

Yup, we would agree. Thank you guys.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

John, with respect to your question on cushion for impairments, we are not worried about impairments at this point. Business is good. We have \$9 billion of inventory, \$6 billion of that is backlog, \$500 million is option contracts for land and the balance is land and the land that we have right now is generating margins in the upper 20s to low 30s.

A

John Lovallo

Analyst, UBS Securities LLC

Thanks guys.

Q

Operator: Our next question comes from Rafe Jadrosich from Bank of America. Please go ahead.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Hi, good morning. It's Rafe. Thanks for taking my question. So, can you give a little bit more color, you sort of mentioned how the priorities of capital allocation are maybe shifting a little bit, how do you think about buying land at sort of the current prices today compared to repurchasing your stock which is now trading below the book value that you expect at the end of the year? And then you also mentioned sort of having a higher return hurdle for land underwriting, can you just give a little bit more color on sort of where that's been and what your expectation is going forward?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. We love our land position to have 85,000 plus lots owned or controlled, the business is selling call it 12,000 homes a year plus or minus, puts us in a, I think enviable position. I'm very proud of the pivot we've made to have more of that land optioned than owned. We talk about it all the time, we buy land at main and main, even with the affordable luxury move, okay, so block of main and main.

A

But it's still really good quality and because of that land, our land position, because of how it is structured, we are – we have tightened our underwriting. We expect to buy less land. We have the land in place to show significant growth over the next couple of years. We're not ready to guide yet to 23 community count. But I'll tell you, it's going up and it's going up based on the land we have and it should be going up significantly. And so we look at a combination of gross margin and IRR and about a year ago that combo was 50, about six months ago that combo was 55 and today that combo is north of 60. And on top of that, we have basically doubled the contingencies, we're putting on top of building costs and the contingencies we're putting on top of land development and we're not underwriting off of the super frothy hot sales pace, call it of three months ago. We're being more conservative when we throw the sales pace assumptions in or when that land comes to market and we actually start selling homes.

So sorry for getting into weeds, but you asked the questions and I'd like to get into the weeds and that's how it's moved, and has it slowed down land buying, yes, it has. Does it send a message to the teams, yes it has. Has it

freed up significant cash flow, yes, it will. And we will use that to reduce debt to continue to give all of our shareholders a nice dividend and hopefully buy back or hopefully not because the stock goes up but have the opportunity to continue to buy back our stock and that's the plan.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Rafe, we heard from a few folks that maybe my mention of book value was a bit garbled. So, I'll repeat it. Our book value at the end of the quarter was \$46.51, we project it to be \$53 per share at the end of the year.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Great, thank you. That's really helpful.

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

Q

Hey guys. It's actually [indiscernible] (30:52) because he's feeling a little bit under the weather today. Can you tell us how your affordable luxury product is performing relative to your true luxury product? For instance, we understand that the typical Toll buyer is pretty insulated [indiscernible] (00:31:08) as you kind of highlighted, but your affordable luxury communities, are they seeing a bigger change in demand metrics than your traditional communities given the rates? Like, if 50% of your Toll communities are not restricting sales, what's that ratio for the affordable luxury ultimately and how do you think about cycle times between those two?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, I'm going to answer your question in relation to the comments we've made about the last month because I think that's what you're really asking and as we've said, the market is still good, demand is still good. However, we have noticed in the last month, as we expected, with all that's going on with rates and with home prices being up and with inflation concerns and with the stock market all over the place and with what's going on in Europe, we did expect that we would see some caution from buyers.

And as to your specific question, affordable luxury is performing a little bit worse than the luxury and the active adults. We would have also expected that. As you come down in price, the monthly payment becomes more important and therefore, I think you're more concerned about affordability. That doesn't mean that market has rolled over by any means, but if I look to Boise Idaho, as an example, where our homes are less expensive or I look to probably now a third to a half of our Phoenix operation, which is less expensive, those two areas are good examples of where that side of the business, the affordable luxury has not performed as well and that's what we expected. South Carolina is also an example where Myrtle Beach or in Greenville and we're in Charleston, those are all overpriced market for us and they have similarly been a bit slower over the last month than the rest of our business. So, it's common sense for the reasons I just gave and we are seeing it in our results.

Q

Okay.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And I'm sorry as to your US cycle time...

A

Q

Yeah.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

It's a couple months shorter to build the less expensive homes. They're smaller, they're easier, they're simpler they have less upgrades, so a couple of months less.

A

Q

Okay, yeah, that's understandable. Thank you very much for that. And your commentary suggests 3Q order trends will be down double digits. Is this due to restricting sales in the quarter or are you factoring in some softening demand as well into that outlook?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah.

A

Q

Also with the 10-year down nearly 40 bps in the last three weeks, if it continues to move down over the next couple of months, could there be an upside to those orders?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah, it's really hard to talk through the summer when we're just now seeing in the last month some signs of caution from buyers. So, I think the answer to it is a combination. Now we went back and looked at the 10-year period of time before COVID. Our third quarter on average was down about 15% from our second quarter sales and that's not that market softened in those 10 years what may hit, that's seasonality. May, June and July are – tend to be slower sales months in normal times because your kids graduate, you've got weddings, you open up the summer house and off you go. And we didn't see that the last two years because of COVID, we didn't have seasonal patterns.

A

It feels like one to three weeks in, one month in, that that is occurring. But the answers to why, I boldly said I believe Q3 will be lower than Q2 is looking back at those 10 years before COVID, the return of seasonality, we are still on allocation. So, we are managing our sales as we get caught up with production and some buyer sentiment that we are feeling. So, it's really a combination of all of those, but it will be very hard to predict.

I think buyers are – some buyers, now demand is still so strong that it outweighs supply and we still have many markets that are really good, that's where we've tended to still allocate sales, limit sales. We also have 15% of our

communities that are going through the best and final sealed-bid process, where we are still achieving higher winning bids than our minimum bid amount. But there is no question that I think there are some buyers that are taking a more measured approach and that's – I think that's what we're up against.

We're using the opportunity here to control sales to limit sales, it's not because of demand. We're not saying, okay, we're going to slow sales that year because we're feeling less demand. It's all about catching up with production and when you have a community that is still quoting a 14-month delivery, even 6 months ago buyers were saying I just don't want to wait that long. If we can get that back to normal 9, 10 months, I think we're going to have – which is what we're striving to do and that's the purpose of limiting sales, we're going to have a much better indication sort of as that buyer sentiment, is it that they just don't want to wait 14 months or are they just being more cautious because of all these other affordability and macro issues that we're facing at the moment.

Q

Yeah. Thank you very much.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

You're welcome. Thank you. Good question.

A

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

Charles Perron-Piche

Analyst, Goldman Sachs & Co. LLC

Good morning, everyone. This is actually Charles Perron on for Susan today. Thanks for taking my question. Obviously, you gained a ton of price in the quarter with average order price up 23% year-over-year in 2Q. I recognize that this should continue to support results into 2023 given your backlog. But for those houses that you've been selling over the past month, have you seen any changes in your ability to push price and get higher ASP to offset the inflationary pressure that you've seen?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah. So for the last year-and-a-half we've been running approximately 5% price increase per quarter. It's not exact to every quarter but that's what it averages out to. Part of that is this best and final offer process where we'll have the clients decide how much they're willing to pay and bid against each other and drive the price up even higher. But a lot of it is our own increases to our price sheet. We do not expect it to continue at that pace. We still have some pricing power. We are still raising prices today in a limited number of locations. As I mentioned several times now, we still have the best and final offer sealed-bid process going in 15% of our communities. But we don't expect at the moment particularly as we head into the summer and we talked about seasonality that we don't expect to continue that cadence of 5% price increase a quarter. I will say we have no incentives out there. We're not contemplating incentives – where – there are not communities out there that are feeling the need to incentivize to drive sales. So that's why I said in my comments and in the release last night that we're still in a good market but I do not expect that 5% per quarter to continue.

A

With respect to whether we are offsetting cost increases through our pricing, we have more than exceeded cost increases through our pricing over the last 18 months, hence the increase in margin and the increase in guidance

on margin in 2023. We'll have to see how it plays out through the summer as to how much pricing power we have. While costs are going up, we do feel like we have good controls over those costs. I've mentioned that we have increased our contingencies and that's not just for the land buying I mentioned, but we've increased our contingencies on our open communities and are still comfortable with our ability to drive that gross margin higher. So I think we'll have to wait and see what develops over let's call it the next three months to know how that pricing power will relate to cost pressures.

Charles Perron-Piche

Analyst, Goldman Sachs & Co. LLC

Q

That's very good color. Thanks very much for this. And I guess as a follow-up, can you provide an update on your community ground growth outlook if we see slower demand. I understand that you expect 2023 community count to be up year-over-year but if we were to expect like I say slower demand going forward, is there any way for you to flex that community count opening to maybe protect your sales base and how does this change your outlook if you were to see moderating demand trends going forward?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We can always flex our community openings. The only time we [indiscernible] (00:42:22) if we're up against some permit that's about to expire and we have to get the roads in where we lose the years of hard work in gaining the entitlement but that's very rare. Usually, permits have a pretty long shelf life and we don't feel that pressure. So we're not going to move forward and put roads in and build beautiful model homes and open for sale if we haven't studied in great detail the current market conditions, the financial metrics of that community with costs and pricing and then of course we make the decision to go or not go.

So right now, there is none of that being contemplated. We have the land, we have a pretty good idea as to when we gain entitlements and when we're ready to open. Much of this land, two-thirds of this land that we control was put under contract either in the early days of COVID or more likely pre-COVID before land prices went up. And so we're sitting on terrific margins and a lot of this land that is positioned to be opened in new communities in later in 2022 or in 2023, but there is always the ability to pivot if market conditions suggest that we should.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I think in the short-term, a slowing of sales would actually lead to community count growth because we have fewer sale-outs than we currently project, right, but it probably will not in the short-term change what we plan to open.

Charles Perron-Piche

Analyst, Goldman Sachs & Co. LLC

Q

That's very good color. Thanks for the time guys.

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

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Hi. Good morning, everyone. Thanks for taking my question. I'm going to start off with a broader one. Are you able to provide any data points on traffic at this point in time or even orders momentum in May, exiting April? Also you mentioned that 15% sealed auctions are still on, what was that a quarter before?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

I'm sorry I did not understand the second part of the question. I got traffic, we'll get to that. The 15% was what?

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

The sealed auctions that you mentioned, what was that a quarter before?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Oh, thank you, final – but thanks, that's in final and sealed, thank you. Guys, why don't you pull that up. With respect to traffic, there has been a modest slowing of foot traffic and web traffic through the month of May, which we didn't see in the prior two Mays but it's consistent with the more seasonal patterns that we've talked about pre-COVID. It's nothing that alarms us but it is we're keeping an eye on it. And so that both web and foot traffic is down on a typical seasonal basis. We are encouraged that what we call web leads, which are those people that spend time on our website and then either make their way to our sales office by foot or send in an e-mail request through the website seeking more information. Our definition of leads as a percentage of traffic that becomes a lead is holding up but the amount of traffic is down, as I mentioned, on the consistent seasonal pattern.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

In terms of best and final offers, the end of our first quarter was in the neighborhood of 25% to 30% of our communities and now it's at that 15%.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you, Marty.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Q

Got it. Okay, no, that's helpful, thanks. My follow-up is on the guide cadence – the implied guide for Q4. Within that full year guide pullback in terms of closing units, is there a portion that's unsold yet? And I asked it because [indiscernible] (00:46:51) backlog delivers in 2023 which means in a roughly 6,000 deliveries in the second half but you're guiding to 7,000 closings as well. I'm sure it's an approximation there, but just curious, is there a portion that still unsold within the Q4 guide?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah, there are 500 to 1,000 units that we would expect to sell and settle between the end of Q2 and the end of Q4 and that will come from homes under construction or our spec inventory that's a normal amount and actually we could probably sell more but again we are trying to build our spec count back up to more normal levels.

Deepa Raghavan

Analyst, Wells Fargo Securities LLC

Got it. That's what I thought. Appreciate the color. Thanks very much and good luck.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you.

A

Operator: Our next question...

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

I have one quick clarification, thank you Wendy Marlett, our amazing Chief Marketing Officer. When I said there are no and I think I said that word very strongly, incentives. What I want to clarify is when we sell \$1 million and \$2 million houses even in a greatest market we've ever seen, we may give the customer \$5,000 or \$10,000 towards upgrades to make them feel good and that's in place, that's been in place. We're not increasing any incentives anywhere. I mean, I just want to thank you, Wendy. I want to make sure that that is clarified.

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 taking the questions. First question, Doug, I think you just touched on this briefly, but the spec strategy last quarter I think you noted you were starting more specs trying to replenish the inventory there. I think you just kind of highlighted that that remains the strategy today. But can you just talk a little bit about where you are from a spec count perspective across the company under construction, completed, presumably you don't have much if any. But are you kind of back at the levels where you want to be or you still kind of ramping the spec activity, how are you thinking about that given your comments about the slight moderation in demand as well?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. Yeah, it's a great question. So don't be alarmed, we're not a spec builder, we built this company on build-to-order. We know that \$1 million decline is very discriminating. It's a very important home in their life, not their first one generally and they want to design it their way.

A

We think the right mix is 80% build-to-order, 20% spec and even on the spec, in many cases, we open that for sale when the client can still go to our design studio and pick their finishes. So it's rarely finished spec inventory for the same reason. At that price point, the buyer wants particular kitchen cabinets and the countertop on their flooring. And so through COVID, we got so hot, we've sold so many homes, we put our attention on our backlog, we were unable to keep up with mixing specs into production and we fell far behind that 80/20 balance.

And so as we mentioned on the last call because we had some very long quoted delivery times at some of our communities, then you walk-in, you want your build-to-order home and we tell you, I'm very sorry, but it's going to take 15 months. We made the right decision, strategic decision to put those types of communities on allocation, limit sales but still start more unsold homes, so we could get back to the 80/20 mix. So it shouldn't hurt revenue

down the road because we'd have those homes completed, at the same time, we just might not have the sale today. And so, we've started more homes in Q2 than we sold. And I think we'll do the same thing in Q3, but we're not caught up, we're not close to 20%. I'm not sure, we'd get to 20%. If the market shows signs of softening, we will be more careful. We understand the business, we are not interested in sitting on completed spec inventory in a tough market.

Historically, spec homes were incentivized more than build-to-order. Through COVID, we know that wasn't the case. If you held a home longer and you wrote out the price appreciation, that spec would have a higher margin than a build-to-order, but that's unusual historically in this industry. Typically, build-to-order drove higher margin and I'm not saying we're heading back into that yet, I don't know, but we will start more but we will, I don't think, be able to approach that 20% and that's the cap. We are not looking to go beyond that, so...

Alan Ratner

Analyst, Zelman & Associates

Q

Got it. And the key point there just my take away from what you just said is, in spite of what you're seeing in terms of slight moderation in demand that hasn't impacted your willingness or aggressiveness to start more homes than you're selling. You still think that the demand is going to be strong enough as your bring these homes to market to absorb it at strong prices and strong margins.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We do and then with respect, you – I think you asked a little bit, Alan, about how much do we have at different stages. Right now we have about 1,000 units, so call that a little bit less than 10% of our annual sales that are at or beyond foundation. And that was – is what will feed into Deepa's comment about, how much of your full year is sold. Marty gave a range of 500 to 1,000 specs. I think the exact number guys, we think is about 600, I just heard.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Q3 and Q4.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

For Q3 and Q4. There are about 600 more sales we need to deliver in Q3 and Q4, but we have 1,000 spec homes that are at or beyond foundation. So we're in very good shape. But we're being thoughtful on every week we study where we should be starting homes, what the market conditions are in that locale as to whether we should continue to start specs. And yeah, I mean, you know, we've always been very conservative when it comes to spec building. I'd like to get back towards 20% if the market continues to be good, but we can easily pivot on that and we're not going to pivot up anything but pivot it down.

Alan Ratner

Analyst, Zelman & Associates

Q

Perfect. And I appreciate the comments there, Doug and if I can just add one more, the 2023 margin guide to be up obviously that's a reflection of the 50% of your backlog that's in there presumably at margins similar or better than what you're expecting in the fourth quarter of this year. Doug, you've made this comment the last several quarters that, the home you're selling today is the highest gross margin in the company history. And I'm just curious is that still true today or has that maybe been a little bit more mixed given the fact that you are dialing back the price increases and what you're seeing in the market?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. I chatted about that a few questions back. With 5% price increase per quarter for the last 18 months, we have been more than offsetting cost increases. I do not anticipate continuing to achieve 5% price increase per quarter with what we've seen in the last month and what we've been discussing. So it's hard to say yet whether we will have enough pricing power to offset cost increases, if the market does flow do costs come down, we have a nice tailwind with lumber coming down that I think will benefit us in at least the second half of 2023.

So it's very hard to say, Alan, but certainly with what feels like a bit less pricing power today, I can't sit here and confidently tell you as I did the last few quarters that the next home sold will be at a higher margin. I think it will be at a similar margin at the moment, I'm very happy with the margin, but we're just going to have to see how demand plays out.

Alan Ratner

Analyst, Zelman & Associates

Q

Makes sense, all right. Appreciate the thoughts guys.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks. Take care.

Operator: The next question comes from Buck Horne from Raymond James. Please go ahead.

Buck Horne

Analyst, Raymond James & Associates, Inc.

Q

Hey, thanks, good morning guys. Congrats on the quarter. Let me start with kind of a question that's probably difficult to answer but one I get a lot. The market – the current prices for your stock in the group, I mean, the market is anticipating some sort of housing cataclysm, almost similar to a 2008 style meltdown. The question is kind of what would it take from here to try to help the portfolio manager understand it downside, in terms of what kind of home price declines would have to take place or margin erosion to drive some sort of land impairment cycle from here. What kind of scenario, what does it take from here to get to that point?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah, Buck, I guess there's couple of points, I'll go through our \$9 billion of inventory, as I did earlier. \$6 billion of that inventory is backlog homes. So, I think there's very little risk associated with those. We haven't seen cancellation rates, they have 25% to low 30% margins in them and they're not in our book value yet. We've talked about them getting into our book value by the end of the year but then there's further book value appreciation we would expect into next year as the balance of those backlog homes deliver.

Secondly, I talked about another \$2.5 billion of owned land that's in our inventory. We feel very good about the underwriting of those. Those also projected roughly 25% to 30% gross margins. So, we have to see significant cost growth or price drops and we are not seeing that at this point. And then the last piece is the \$500 million of option deposits or some costs we have on deals that are in our options land portfolio. And again that's not a big number to control 46,000 lots. There may be some occasions in there, where we choose not to proceed with a deal as we saw in the first quarter. But here in the first and the second quarter, the first and the second quarter,

we wrote off \$4 million of costs in those – associated with those as the underwriting of those deals didn't work for various reasons as part of our diligence exercise.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Where we didn't get approval...

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

We didn't get approval...

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Not that the underwriting, it may just needed certain deals [ph] fizzle out (00:59:13).

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Approvals didn't come through maybe construction cost for land development were more substantial than we thought and the seller wasn't willing to renegotiate. So, we are not worried about impairments.

A

Buck Horne

Analyst, Raymond James & Associates, Inc.

Great. Yeah, that's helpful. I appreciate the color there. My last question is just kind of on switching gears to the rental side of the business, I'm just wondering with the rise in rate here, obviously multi-family rents are continuing to go up really, really strong, single-family rental as well. Do you anticipate growing your capital investments or the mix of capital into the rental side of the business or how do you think about the optionality of growing the JV partnership on the SFR side or anything related to the rental side?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Yeah we love the business, it's performing very well. Our joint venture with EQR is fantastic. The teams are working really well. EQR is a great partner, there's more and more opportunities for us to co-develop with them and then they take us out at stabilization. As we've mentioned, we're now committed to sell all of the apartment building that stabilization to produce earnings that become more predictable for all of you and we see that business growing, but we're not having to put more investment into it because we're turning assets quickly as we get more and more assets and they sell us stabilization, that money can be recycled.

A

On the SFR side, we have a \$25 million investment in a joint venture with a substantial Wall Street partner and BB Living. We like the SFR business. We'll continue to co-invest in that venture. There may also be some opportunities outside of that venture of some smaller assets that Toll Brothers owns or we sell some homes out of the gate to SFR operators that tends to be our lower priced locations. I know a lot of the other builders are doing that, and we do have some carve-outs with the BB deal that allows us to do that. So, we like both the traditional multifamily, the SFR business, we're going to continue to invest in it. But we're going to show earnings out of it by selling everything at stabilization.

Buck Horne

Analyst, Raymond James & Associates, Inc.

Thanks guys.



Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you.



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. I hope you have a wonderful summer, take care.

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

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