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Toll Brothers, Inc. (TOL)

Q2 2023 Earnings Call

CORPORATE PARTICIPANTS

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Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

OTHER PARTICIPANTS

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Analyst, UBS Securities LLC

Michael Rehaut

Analyst, JPMorgan Securities LLC

Stephen Kim

Analyst, Evercore ISI

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Alex Barrón

Analyst, Housing Research Center LLC

Alan Ratner

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Mike Dahl

Analyst, RBC Capital Markets LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, everyone, and welcome to the Toll Brothers Second Quarter Earnings Conference Call. All participants will be in a listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] The company is planning to end the call at 9:30 when the market opens. [Operator Instructions] Please note this event is being recorded.

At this time, I'd like to turn the floor over to Douglas Yearley, CEO. Please go ahead.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

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

With me today are Marty Connor, Chief Financial Officer; Rob Parahus, President and Chief Operating Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Wendy Marlett, Chief Marketing Officer; and Gregg Ziegler, Senior VP and Treasurer.

We're very pleased with our second quarter results. As mortgage rates have stabilized and buyer confidence has improved, the increase in demand that began in January has continued through our second quarter and into the

start of our third quarter. This improvement in demand, combined with our strategy of increasing our supply of spec homes into the spring selling season and our focus on operational efficiency, has resulted in second quarter performance that well exceed our guidance. As a result, we are raising our full year guidance across most metrics.

We delivered 2,492 homes in the second quarter at an average price of \$1 million, generating home sales revenues of approximately \$2.5 billion, each a second quarter record. Deliveries exceeded the midpoint of our guidance by nearly 400 units, primarily due to cycle time improvements and an increase in the number of spec homes we settled in the quarter. Adjusted gross margin of 28.3% in the second quarter improved 220 basis points compared to last year's second quarter and was 130 basis points better than guidance.

Our home building gross margin benefited from cost controls and greater leverage on fixed costs from higher home building revenues. Our SG&A expense in the second quarter was \$16 million lower than Q2 of last year. We're benefiting from approximately \$50 million of cost reductions that we have taken over the past year, which we expect to be permanent savings. And we continue to target additional opportunities to become even more efficient.

As a result of the significant beat on our top line and improved margin performance, we generated second quarter pre-tax income of \$430.6 million and earnings per share of \$2.85, up 46% and 54%, respectively, compared to last year's second quarter, both second quarter records. At second quarter end, our backlog stood at \$8.4 billion and 7,574 homes. Our cancellation rate as a percentage of backlog was an industry low 3.9% in the second quarter.

As a reminder, our buyers are financially invested in their new homes as they make sizable nonrefundable down-payments that average approximately \$85,000. They also become emotionally invested as they personalize their homes by selecting their home sites, adding structural options to match their lifestyles and selecting finishes that reflect their tastes. In short, they stick. And the profile of our typical buyer is well suited for the current market. Our buyers are more affluent and tend to have significant equity built up in their existing homes, which better insulates them from affordability concerns and makes it easier for them to move.

In the second quarter, 23% of our buyers paid all cash and those who took a mortgage averaged approximately 70% loan-to-value. In the second quarter, we signed 2,333 net contracts for \$2.3 billion, down 19% in units and 26% in dollars compared to our very strong second quarter last year. Although our second quarter contracts were down on a year-over-year basis, demand has improved significantly compared to the previous three quarters.

As I mentioned on our last call, we saw demand start to improve in January. I'm pleased to report that these more favorable conditions have continued through our second quarter and into the start of our third quarter. Physical traffic, web activity and deposits in the first three weeks of May have all been very encouraging. Overall, buyers appear to be adjusting to mortgage rates that have stabilized in the 6% to 7% range. The shock of last year's abrupt spike in rates appears to be wearing off and buyers are moving on with their lives.

As I pointed out in the past, there is a substantial shortage of homes for sale in the US with housing starts failing to keep up with population growth for at least the past 15 years. Now, with 90% of outstanding mortgages under 5%, the market is seeing the further impact of a low interest rate lock-in effect. Existing homebuyers – excuse me, existing homeowners are reluctant to give up their low-rate mortgages, which has led to historically tight resale inventories.

In fact, according to recent reports, approximately 35% of homes currently for sale are new construction compared to the historical norm of between 10% and 15%. This phenomenon has become a boon for homebuilders and especially the larger, well-capitalized public builders who are more efficient and better positioned to take advantage of opportunities compared to smaller private builders. With such low levels of resale inventory on the market, buyers are gravitating to new homes. As they do, they benefit not just from the opportunity to buy new, but they can also take advantage of incentives like rate buy-downs that are generally not available on resale homes.

In addition to the underproduction of new homes in this country and the low level of resale inventory, there are many other factors that continue to support the housing market. These include favorable demographics with millions of millennials and baby boomers on the move. Millennials, in particular, are buying their first home later in life when they have higher incomes and accumulated wealth.

Migration trends are driving the population South and West, which not only increases demand in these markets, but alleviates some of the affordability pressures as buyers move from high-cost to low-cost markets. More flexibility in the workplace also supports this migration and the housing market in general as buyers place a greater emphasis on their homes. These trends have staying power that we believe will continue to support housing demand for years to come.

A key part of our strategy heading into the spring selling season was to focus on increasing our supply of spec homes to support deliveries in the second half of fiscal 2023 and throughout 2024. With demand better than expected this spring, this strategy is paying off. Demand for our spec homes in the second quarter remained strong, representing approximately 40% of our orders in the quarter.

As a reminder, we define a spec home as any unsold home with at least a foundation in the ground. We sell our specs at various stages of construction, which still allows many of our buyers the opportunity to personalize their finishes. For those who prefer an even quicker move-in, when we do finish our homes, we include designer-appointed features that reflect the luxury Toll brand.

Specs also allow buyers to lock their mortgage rates at or near the time of contract. We believe that in this market our spec strategy continues to make sense. With such limited resale inventory, specs fill a significant gap in supply. We expect that specs will continue to comprise between 30% and 40% of our sales for the foreseeable future.

The more stable environment has allowed us to increase price in more than half of our communities. Factoring in base price increases and incentive reductions, we have increased price by an average of approximately \$25,000 per home in the second quarter. We also saw modest improvements in our supply chain and some easing in labor constraints, especially at the front end of the construction process. As a result, we saw our cycle times improve by approximately two weeks on average across our communities during the second quarter.

The improvement in cycle times, combined with a stronger demand environment and our focus on increasing spec production, has led us to increase our full year deliveries guidance. We now expect to deliver between 8,900 and 9,500 homes, an increase of approximately 700 homes at the midpoint of our previous guidance. We are also increasing our guidance for our full year average delivered price to between \$975,000 and \$995,000. This translates to a home building revenue projection of approximately \$9.2 billion for the full year. We are also increasing our full year adjusted gross margin guidance from 27% to 27.8%.

As I mentioned earlier, we expect to benefit from greater fixed cost leverage on higher revenues. We are also benefiting from being a more efficient builder with a streamlined portfolio of floor plans and option selections. On the land front, we remain committed to our disciplined and capital-efficient land acquisition strategy as well as our focus on returning capital to stakeholders.

At the end of our fiscal second quarter, we owned or controlled 71,300 lots, of which 49% were controlled and 51% owned. Approximately 7,500 of these lots are already committed to buyers in our backlog. Excluding these, our controlled land represents 55% of lots. This provides us with sufficient land needed for significant growth well into the future. Therefore, we will continue to be very selective on new land deals as we apply our more rigorous underwriting standards.

Our financial position and liquidity remain very strong. In the second quarter, we retired \$400 million of senior notes and extended our term loan and revolving credit facilities out five years. At quarter end, our net debt to capital ratio was 23.5%.

We also purchased \$84 million of our common stock at the average price of approximately \$58 in the second quarter and paid \$46 million in dividends year-to-date. In March, our board approved a 5% increase in our quarterly dividend. These actions reflect our confidence in the business and our commitment to delivering returns to shareholders.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. Good morning, everyone. As Doug mentioned, we had a terrific second quarter. We beat our guidance for home building revenues, adjusted gross margin, SG&A and earnings. Our quarter-end backlog of 7,574 homes and \$8.4 billion is strong, with high embedded gross margins, and our cancellations have remained low. And we believe we have the right strategy in place to replenish this backlog and support deliveries in the second half of fiscal year 2023 and throughout fiscal year 2024.

Home building revenue of \$2.5 billion on 2,492 delivered homes were both second quarter records, increasing 14% in dollars and 4% in units compared to one year ago. We signed 2,333 net contracts in the second quarter for \$2.3 billion. The average price of contracts signed in the quarter was approximately \$975,000, down about 2.1% compared to the first quarter of fiscal year 2023. This decline was due to mix. As Doug mentioned, we actually raised price an average of \$25,000 per home in the second quarter.

Pre-tax income was \$430.6 million compared to \$295.8 million in the second quarter of fiscal 2022. Net income was \$320.2 million, or \$2.85 per share diluted, compared to \$220.6 million and \$1.85 per share diluted one year ago, leading to a book value per share of \$58.67 at quarter-end. Our second quarter adjusted gross margin was 28.3% compared to 26.1% in the second quarter of 2022, and that was 130 basis points better than projected. The improvement was due primarily to better cost control and fixed cost leverage on a higher-than-expected home building revenues.

As Doug mentioned, we are raising our full year adjusted gross margin guidance from 27.0% to 27.8%. In our third quarter, we expect adjusted gross margin of 27.7%. During our most recent quarter, impairments and write-offs in home building cost of revenues were approximately \$11 million, about \$6 million of this related to sunk pre-development and walk-away costs, with the remainder related to three operating communities.

SG&A, as a percentage of revenue, was 9.1% in the second quarter compared to 11.1% in the second quarter of last year, and that was 210 basis points better than projected. SG&A expense was \$16 million lower in Q2 of fiscal year 2023 compared to last year's second quarter. \$13 million of this improvement was from lower G&A costs, with selling and marketing expenses \$3 million lower.

As we enter the second half of the year, we expect our G&A costs to remain relatively flat on a dollar basis as we continue to benefit from previous cost reductions, with modest increases in selling and advertising costs as the homes we sold in the slower second half of fiscal year 2022 are being delivered over the next several quarters. Overall, we are projecting full year SG&A costs to be approximately 10% of home building revenues, which would be about flat compared to fiscal year 2022, and which represents 100 basis point improvement from our prior guidance. For the third quarter of fiscal year 2023, we expect SG&A to be approximately 9.7% of home building revenue.

Second quarter JV, land sale, and other income was approximately \$1 million, in line with our breakeven guidance. We are maintaining our full year guidance for this item at \$125 million. We expect third quarter joint venture, land sales, and other income to be approximately \$25 million, with the balance in the fourth quarter coming primarily from several apartment projects we are working to sell before year-end. Our tax rate in the quarter was 25.6%, slightly better than guidance of 26%.

We finished the quarter with a net debt to capital ratio of 23.5%, \$762 million in cash and equivalents, and \$1.8 billion available under our \$1.9 billion revolving bank credit facility. During the quarter, we retired \$400 million of 4.375% senior notes at maturity and extended the term loan and revolving bank credit facilities out five years. As a result, we have no significant bank or senior debt maturities until fiscal 2026. This financial position provides us with ample flexibility to both grow our business and return capital to our shareholders.

We are projecting fiscal year 2023 third quarter deliveries of between 2,350 and 2,450 homes with an average price of \$1,015,000. As Doug noted, we expect full year deliveries to be between 8,900 and 9,500. We have also increased our projected full year average delivered price to be between \$975,000 and \$995,000, which is \$10,000 above our prior guidance at the midpoint. We expect interest in cost of sales to be approximately 1.5% in the third quarter and for the full year as we continue to benefit from our reduced leverage.

We expect community count to be approximately 360 at the end of the third quarter and approximately 385 by fiscal year-end. We also expect continued community count growth in fiscal year 2024. We project a tax rate of approximately 26% for the third quarter and 25.7% for the full year. Our weighted average share count is expected to be 111 million for the full year and 110.5 million for the third quarter. Based on all these factors, we project earnings between \$10 and \$11 per diluted share for the full year with a return on beginning equity approaching 20%.

Now, let me turn it back to Doug.

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 once again thank all of our Toll employees for their hard work this quarter. Your dedication and commitment to our customers is key to our continued success.

With that, Jamie, let's open it up for questions.

QUESTION AND ANSWER SECTION

Operator: And ladies and gentlemen, we'll begin the question-and-answer session. As a reminder, the company is planning to end the call at 9:30, when the market opens. [Operator Instructions] Our first question today comes from John Lovallo from UBS. Please go ahead with your question.

Spencer Kaufman

Analyst, UBS Securities LLC

Q

Hey, guys. Good morning. This is actually Spencer Kaufman on for John. Thank you for the question, and nice quarter. Apologies for starting off with a glass-half-empty question here, but rates have certainly ticked up over the last few weeks, and you guys kind of alluded to this, but have you seen any impact to demand thus far? And if rates sort of stay at 7%, would you expect incentive activity and cancellation rates to pick back up again for the industry?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Spencer, the answer is no, we have not seen any drop in activity over the last few weeks as rates have moved up a little bit. In fact, May, if we look back historically, just because of seasonality, as the spring season begins to wind down and May represents graduations and weddings and opening of summer homes, May generally is down, historically, for the company, about 30%, it's off from April. And that's a historic number that goes back long before the COVID years. And we're only three weeks here in, but May right now is trending significantly better than being down that 30%.

In fact, we look back to 2019, and this May so far through three weeks is up fairly significantly over May of 2019 when rates were in the low-4s. So, I don't have that crystal ball as to where this market goes if the rates continue to sit at 7%, but so far, for the last couple of weeks, we're very pleased with the continued very strong activity with rates at that level.

Spencer Kaufman

Analyst, UBS Securities LLC

Q

Okay. Yeah, that's actually really encouraging and good to hear. Maybe just on – I think you guys mentioned that you've been able to increase pricing by about \$25,000 per home in the quarter. Just curious as to which markets you're finding an ability to do that or a little bit higher than that, and maybe which markets are being a little bit more stubborn right now.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, it's around the country. We don't raise price by market, we raise it by community based on the activity. The brightest spots for us would be Atlanta – excuse me one second, would be Atlanta, all of Texas, Florida, California, which is doing really well, and Pennsylvania, New Jersey. Those are the strongest. But again, we're seeing that pricing power and good activity around the country. The softest markets today would be Seattle. And while Phoenix has improved, it's still not back to where we would hope it would be.

Spencer Kaufman

Analyst, UBS Securities LLC

Okay, got it. Thank you, guys, and good luck.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

You're very welcome. Thank you.

A

Operator: Our next question comes from Mike Rehaut from JPMorgan. Please go ahead with your question.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Thanks. Good morning, everyone, and congrats on the results.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Mike.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Mike.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

First question, kind of thinking about gross margins in the back half, and it looks like the guide is for something a little less than the second quarter. And just trying to think about how the interplay of maybe prior incentives in a softer back half might be influencing that, and given the improved pricing that you've seen in the second quarter, how to think about gross margins in the backlog? And if the back half of 2023 is any good way to think about kind of a launching point into next year, not necessarily talking about guidance for next year, but just some of the puts and takes as you see things playing out over the next few quarters.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. And then, Marty, please follow me. The back half of this year's deliveries are primarily coming from those nine months we had from last May until the end of the year when our orders were down 60% – 60% and 50%. And so, during that time, we had to increase our broker commissions a bit. We had to incentivize a bit more. As you know and we've talked about, we did not chase the bottom, so we were not giving massive discounts to – we were patient, and I think that patience has paid off, but we did have to incentivize more, as we've talked about. The incentive back in that timeframe was in the, call it, \$70,000 per home range. And right now, it's \$50,000 and trending down. So, that's a bit of a headwind, but it's not all that dramatic, particularly since we have the tailwind of lower lumber costs, which will be helping us as we move forward.

A

When you ask about 2024, we're not going to give guidance right now on 2024, except to say that we should continue to have the nice tailwind of lower lumber. Lumber this week just broke below \$400 a thousand board feet as it continue to trend down. And as we've talked about, the last 3.5 months – excuse me, 4.5 months, since

January, have had strong sales and a reduction in incentives, so next year we'll not be delivering very many of those homes during those nine months of slower times that concluded 2022, but will be more reflective of the sales that have occurred in the last four months. So, I'm not – again, we're not going to give those details, but I think that gives you a pretty good flavor of where we are.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I don't have much to add to that, Doug. I think I would just emphasize that we didn't chase the market nine months ago, and some of these gross margins that we have just reported and that we are projecting are reflective of that.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, that makes sense. I appreciate that. I guess, just shifting to the balance sheet and the share repurchase activity, I just wanted to confirm, number one, that the share count guidance – correct me if I'm wrong, I believe it had originally assumed \$100 million of repurchase per quarter each quarter for this year, wanted to know if that's still the case. And secondly, given the strength of the balance sheet – and you've been kind of on a pretty consistent share repurchase cadence for the last few years, if we could expect – if it's reasonable to expect something similar, if not even maybe slightly bigger, just given the strength in the balance sheet and the consistency here of growth potentially.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Sure. Mike, we're about \$100 million into share repurchases for this year. And while we said \$100 million a quarter, our real target is around \$400 million for the year. Our cash flow is generally better in the back end of the year. And remember, we had \$400 million of debt that we had eyeballed to pay off here in April. So, cash flow and cash usage is going to be a little bit more free in the back half of this year. So, we're still at \$400 million, which is \$300 million over the next two quarters. As it relates to beyond that, I don't think we're going to get very specific. But repurchases and return on equity and equity management are all part of the capital allocation strategy.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. Perfect. Thanks so much.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome, Mike. Thank you.

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

Stephen Kim

Analyst, Evercore ISI

Q

Yeah. Thanks very much, guys. Very encouraging, everything you've said so far. I wanted to just pick up on the capital allocation comments there, Marty, particularly on two fronts. One is land spend intentions. Excuse me. We're at a conference, and we're seeing – we're hearing a lot of chatter about how tighter credit conditions for smaller builders is making things very difficult for them and narrowing their range of options for getting projects developed. And I'm wondering whether or not you're seeing that, hearing that, and whether that is, in your eyes,

creating an increased opportunity set to acquire land and, possibly, maybe smaller builders as we look forward over the next year or two, and if that's something that you're increasingly thinking about.

And then, secondarily, with respect to inventory, we would generally think that, as cycle times move back down, that you could free up some of the dollars in inventory in your CIP, construction in progress. But you're also doing more specs, which could push it the other way. So, can you tell me, Marty, whether you think that your overall CIP could benefit from some dollars being released, net of those two factors?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, Marty, you take that one, and then I'll take the first one.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

All right. I think between the growth in community count and the spec strategy that that will offset about equally the cash flow from quick returns. So, I think I'd consider that a neutral, Stephen.

Stephen Kim

Analyst, Evercore ISI

Q

Great.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Okay. And then on smaller builders, the pressure they're feeling with their banking relations, M&A, land, everything you describe and everything you're hearing at this conference you're at is absolutely accurate. We are seeing more land opportunities being presented by smaller builders who are now becoming sellers and not builders. It's interesting because in the last couple of weeks we've seen more improved lots, ready-to-go land opportunities that can feed our pipeline faster because of other builders who have decided they're going to take a smaller profit, but they're going to take a profit and become sellers and not builders. I think that will continue and that will accelerate.

There is profit in their land, and so they're going to get out when they can, because they're feeling the pressure and they are concerned with their more regional and local banking relationships. And so, that same theory, that same concept is also beginning to show itself with local M&A. We are seeing an increase in potential M&A deals, again, this is small privates, as I think they recognize they have a pretty good story to tell, they can put a nice book together that shows the last couple of years of good sales, good margin, and maybe this is the time to try to sell the company because of the banking pressures they're feeling. And so, yes, there is more action in that regard, too. And we'll see where it plays out, but I think it's going to just develop even more.

Stephen Kim

Analyst, Evercore ISI

Q

Yeah, I really appreciate that. I do think that's going to be a very important emerging trend this year and into next year. Lastly, I'm just going to touch on the SG&A comment. I think you had indicated that marketing costs were a little higher during the back half of last year and those are going to be delivered in the back half of this year. Mike already touched on the gross margin. But on the SG&A and the marketing costs, I believe you put agent – or agent bonuses and stuff like that into your marketing costs. Is it reasonable to think that these bonuses or whatever, your overall external agent commissions went up during that ugly period and are trending back down

now? And if you could give us some sense of maybe how much we should think that dynamic has – how big that dynamic is.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I think at this point, Stephen, the agent cost definitely did go up during that time. They haven't quite come down yet. I think the marketing spend has moderated a bit from what it was then. And I think the guidance we've given for the back end of the year, we're very comfortable with and we'll leave it at that and see where the market goes from there.

Stephen Kim

Analyst, Evercore ISI

Q

All right, it was worth a try. All right, thanks guys. Great job.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks, Steve.

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

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Hi. Good morning. Thanks for taking my question. So, you gave the spec percent of orders at 40%. How much was deliveries – what percent of deliveries was spec in the quarter? And then can you just talk about the spec strategy going forward and longer term?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, 25% of deliveries in Q2 were spec and we are comfortable with 40% spec mix moving forward. We think the huge hole that's being left in the retail market due to the lock-in effect that I spoke of in my prepared remarks is here for some time. And the spec strategy fills that void. It's been very successful for us. And so, 40% is a number that we are comfortable with.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

It's very actively managed at various stages of construction. A spec target is set for each community that's about to open. And the teams are very familiar with how to manage, not getting over-spec'd and trying not to be under-spec'd.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right. So, if you have, as an example – just to make the math easy, if a community is running 25 sales a year, then we may say, in that case, okay, this is a good spec market, let's have 10 a year be spec, but they're getting cadenced out. And as I mentioned, we count a spec from foundation forward. So, we may have three or four between foundation and framing, and then two or three between framing and drywall, and then two or three close

to finish. And if you buy that – if you choose one of those at the earlier stage, you can still go to the design studio and customize it to your lifestyle. But if you want a quick move-in, then you may pick one that's further along where we have picked the finishes.

Remember that the new home spring season generally runs from January to April, and the used home, the resale market, generally runs from April through July. And so, right now, we are in what you would consider the end of a new home spring season, but the beginning of a used home, a resale spring season. And as the buyers that thought they wanted to resale because they want to move in quickly, they want to get the kids in by August so they can start the new school year without moving boxes, particularly if it's a new school district, they're hitting the market now and realizing there is no inventory. And so, they naturally gravitate to the new homes where we now have spec available for them that can get them in in a shorter timeframe.

And that's why I believe May has been so good for us and why I believe there is an opportunity, we'll have to see how it plays out, that the new home market this year may extend and continue into the historic resale market of the summer months because of this hole that we are filling in that vacant resale market.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Thank you. That's really helpful. And then, just to follow up on some earlier comments on sort of the gross margin cadence. You talked about how in the second half of the year you're delivering homes that were sold when the market was softer. For the orders that you're taking today, are you seeing a sequential improvement on gross margin from prior quarters because the incentives are down and you're [ph] still – that you're seeing (00:40:36) the tailwind from lower lumber costs?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, the gross margin today is definitely better than the gross margin for those homes that were sold between May of 2022 and December of 2022. And we are seeing a reduction in incentives or an increase in price, as we mentioned, of about \$25,000. So, the answer there, of course, is yes, with the only, what I'll call, modest headwind to that being that spec margin has sort of reverted back to the pre-COVID margin, which is modestly lower than the to-be-built margin. Remember, through COVID, there was a premium margin, there was a premium price for specs because the market was so anxious to get into a new home and it was taking so long to build to-be-builts because of the disruption in labor and supply. We have now, as an industry – and I think you've heard it from the others – reverted back to where the spec margin is modestly below to-be-built. So, that is the only minor, what I'll call, headwind to what I described as the other tailwinds of better market today than we saw last year, lower lumber costs, and a reduction in incentives, increase in pricing in more than half of our communities.

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

Alex Barrón

Analyst, Housing Research Center LLC

Q

Yes. Thank you. In yesterday's new home sales report, it showed that the growth is starting to come back in year-over-year orders and it showed that it was mostly predominant in lower priced houses. So, I was curious if these specs that you guys are starting, are they more focused on the affordable luxury segment or how are you guys thinking about that?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Alex, they are not. We are building spec around the country. But of course, as we've gone down in price a bit with the affordable luxury initiative we've been talking about, and if you look at the new markets we've entered over the last three or four years, Atlanta, Tampa, Charleston, Greenville, Myrtle Beach, Hilton Head, Boise, Idaho, Salt Lake City, San Antonio, those are some of our more recent entries, they tend to be lower priced. So, our footprint geographically, and therefore by price, has certainly come down. So, we're building more spec in less expensive areas not because of a strategy, but more because that's where we now build.

About 45% of our sales right now are in what we call internally this affordable luxury price point. 35% are true luxury and 20% is age-targeted. And so, the mix of the company has now come down, which is making us even more confident in this spec strategy, because obviously at the lower prices, there is going to be more demand for the spec. But that does not mean in Southern Cal and in Northern Cal and in some of the Texas markets and in Denver, and I can go on and on, higher priced areas we are not building spec. We're very deliberate. We're very thoughtful. I took you through before sort of the strategy of how the specs are cadenced out so there are different stages of construction. But the spec strategy is nationwide, but because of our mix, it's now more in – naturally targeted to a bit lower than it would have 5, 10 years ago.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Just to follow on that mix comment from Doug, the stats he gave of 45% affordable luxury are units based. If you were to do it dollars based, it would be 35% affordable luxury and 45% luxury and 20% active adult. So, swing 10 percentage points between units and dollars between affordable luxury and luxury.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, I'm a marketing guy, I talk units, and Marty is a finance guy, as he should, he talks dollars.

Alex Barrón

Analyst, Housing Research Center LLC

Q

Got it. That's very helpful, guys. And then, I thought your comment on the private builders selling land and that opening up M&A opportunities, that seemed very interesting. So if you guys were to consider some potential M&A with private builders, what would be the criteria? Is it more geography based? Is it more large – increasing the size of an existing market or more like entering a new market? Or what is the way you guys would think about a potential M&A opportunity for you there?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We're really happy with the geographic footprint. So, it's not to say there wouldn't be a builder of interest in a market that we're not in yet, but it's more likely that the M&A would make us bigger, more diverse in one of our existing markets. We'll just have to see how those deals flow. But as I said, I think it's more likely that it goes that route, which means it becomes a big land deal because we have an organization, we have a brand we have to be careful not to pay too big of a premium or not using that builder to enter a new market. So, the deal flow is there, we'll just see.

If we were to do a deal or two, that would certainly help with some deliveries in 2024. And so, we're certainly aware of that and focused on that. But we'll – stay tuned, there is nothing to report right now. We're not in the final stages of negotiation on anything, but we have noticed over the last month or so that activity is picking up.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah. And as it relates to kind of the one-off pieces of land that those builders may choose to sell, it is certainly in our eye sights that deals that they take to market that can drive deliveries for us in 2024 are that much more attractive.

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

Alan Ratner

Analyst, Zelman & Associates

Q

Hey, guys. Good morning. Really great quarter. Congratulations. Doug, first I'd love to drill in on a couple of disclosures you gave early on about your credit profile of buyers and then just some commentary about relocation. First, on the relocation side, do you track the percentage of your buyers that are moving across state lines and what does that trend look like over the last several years and more recently? And then, second, on the down-payment side, I think you mentioned your average LTV on loans is 30% – or excuse me, 70%. Do you track kind of down-payment assistance from family, from parents, and then how that metric has been tracking as well of late?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

As to the latter, no, we don't, and that's very hard to get your arms around.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

But it is a factor.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

For sure.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Anecdotally, it is a factor.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Absolutely.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Positive factor.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

I mean, wealth transfer is growing, right? Look at the demographics, with the boomers, you have 75 million boomers who are going to be passing their wealth down. I mean, I remember when I was 26 years old and I was starting my first job and my dad didn't give me – my parents didn't give me money, but thankfully my father co-signed my mortgage, which is another form of helping out.

With respect to your question about relo, during COVID, when everybody was running for the hills, or the sun, or the beach, we had about 40% of our sales were coming from another state. We're now running at about 35%. That number is up from pre-COVID, but it's certainly come down, as you would expect, as things are back to normal.

With respect to your question about credit worthiness and loan to value, as I mentioned, we're running – we have 23% of our buyers all cash. That's up from about 20%, which makes sense, as rates are higher. Let's put more cash in and take the mortgage. Most of that 23% cash is the active adult, the empty nester, because they're trading down, they have built a lot of equity in their prior home and they built wealth in their life.

Affordable luxury is running about 75% loan to value. Luxury is running about 68% loan to value, and age-targeted, age-restricted, for the reasons I gave about many of those are cash buyers or more cash, that group is running 59% loan to value.

Alan Ratner

Analyst, Zelman & Associates

Q

Very helpful. A lot of great data in there, so thank you. The other question I had, just going back to the spec, built to order, so I was a little surprised that you referenced a small gross margin spread between specs and built to order, only because I would have thought that for you guys, given the margins you generate on options and upgrades and designs, that that would be a greater headwind on a spec product since you're not getting as much of that. So, is that just a function of the timing of when you sell the specs, that you're still selling them fairly early on at this point in the construction process, so you're getting more of those upgrades?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, let's talk about small, because I don't want to mislead. The historic difference between to-be-built and spec is about 200 basis points. And that's about what we're back to right now. Through COVID, it probably flipped the other way.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

The nuance is, that 200 basis points is on a to-be-built sold today and a spec sold today. In reality, what runs through our income statement is a spec sold today and a to-be-built sold yesterday.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

12 months ago.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yes.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

More than yesterday.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right. So, there is a big timing difference there.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Correct.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

But that's what we're showing right now, Alan.

A

Alan Ratner

Analyst, Zelman & Associates

So, to clarify that – on that, though, Marty. So, the 200 basis points spread today, given that timing nuance, if you were comparing apples to apples and homes sold today spec versus BTO, it sounds like...

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

200 basis points.

A

Alan Ratner

Analyst, Zelman & Associates

...it's greater than that. Oh, that's 200 basis points.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

No, today is 200 basis points.

A

Alan Ratner

Analyst, Zelman & Associates

Okay.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right.

A

Alan Ratner

Analyst, Zelman & Associates

Got it. Okay. Thank you.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

And remember, we don't sit on a lot of finished inventory that requires a lot of discounting. And as I went through that cadence of – the example I gave of 10 out of 25 in a community are spec, there's a bunch that gets sold early enough that they can pick their finishes, which is one of the special sauces of Toll. It's one of our Toll advantages that you can go to these design studios and have at it. And so that – there is margin – our design studios are running high-30s gross margin. And so, even on some of those specs, there is the opportunity to drive higher margin because of the timing of when it is being sold.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right. And our specs have a lot of designer-appointed features, a lot of options in them already...

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right. We...

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

...that are in the price.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Our designers and our national decorators that decorate our beautiful models, they get involved in the finishes that go into specs, when Toll is picking those finishes because the house is progressing further along before it's being sold. So, they naturally have some margin built into what we have picked.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Alan, for the...

A

Alan Ratner

Analyst, Zelman & Associates

Got it.

Q

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

...deliveries this quarter, our option upgrades, which includes lot premiums, were \$212,000. And remember, 25% of those deliveries were specs.

Alan Ratner

Analyst, Zelman & Associates

Q

Got it. Really great info, guys. Thanks a lot. Appreciate it.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

You're very welcome. Thank you.

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

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Hi. Thanks for taking my questions. Just a couple follow-ups here. Back on the price increases on the \$25,000, is that kind of a gross base price number? Is it net inclusive of incentives? And can you just help us understand of that \$25,000 if it is kind of all in, what the split is in terms of rolling back incentives versus true base price increases?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, Mike, it's net. So, it's the combination of price increases and drops in incentives. And I would say, it's probably half price increases and half incentives. It just depends upon the community and the amount of demand. We love raising price because you can put that price sheet in front of the next buyer and say, this was last week's price, this is this week's price, and the boss just told me I may have a new sheet next week. Incentive is softer. Incentive is more cautious, of course, because once the price sheet goes up, we're not taking it backwards. But I think it's probably half and half, but that number – that \$25,000 is net.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. Yeah, makes sense. And my second question, Doug, the idea of kind of the tightness in the existing home, it's obviously a huge thematic right now. You guys are primarily a builder that serves a buyer that already has an existing house, and you're seeing strong demand. So by definition, your buyers are making the choice to leave existing homes and trade into your homes and probably giving up low-rate mortgages. [ph] I get the (00:56:25) consensus right now is everyone's kind of [ph] locked (00:56:27) in, but you're seeing every builder who's move up or higher still seeing these buyers come to their communities.

You guys may be a little bit different given your cash buyer and some of the age-targeted, but can you maybe just articulate that a little bit better in terms of what you think is driving that decision to why you're seeing the strength in demand if what you're also [ph] seeing (00:56:52) the existing home tightness is kind of true in terms of people not wanting to give up those rates?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. You got a number of factors that are at work here. Let's not forget 15 years of serious imbalance between homes built and demand population growth, that is in play. Our buyers have equity in their homes. In fact, with a tight resale market, even at a 6.5%, 7% rate, a lot of these homes are selling at or above asking price because there is nothing out there. So when they do sell their house, they're confident they're going to have even more equity than you would normally think in this kind of rate environment.

They're wealthier. They're a move up buyer that has had success in life. But most importantly, there's still buyers out there that want to move up with their life. They want to move the kids to the better school district. They want the more prestigious town. They want the bigger home. They want Toll Brothers, frankly. We're really good at what we do. Our communities are really special. We build, plus or minus, 10,000 houses a year. And so even though rates are higher, there is an affordability issue, there are still a lot of buyers out there that want to move up that have waited long enough. And they see our offering.

And yes, it's more expensive than it was because rates have gone up. But it is time to move on with their life. This is not a financial decision. Does finances play into it? Of course, it does. But this is a family decision. This is a lifestyle decision. And we're it. People aspire to be in our communities. And that's what we're offering. And we're seeing great results because of it.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Mike.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Jamie, is there...?

A

Operator: And ladies and gentlemen, at this time, we'll turn the floor back over to management for any closing remarks.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Jamie. Thanks, everyone. We appreciate all the great questions and your interest and your support. And we hope you have a wonderful, wonderful summer. And we will see you soon. Take care.

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

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