

22-Feb-2023

Toll Brothers, Inc. (TOL)

Q1 2023 Earnings Call

CORPORATE PARTICIPANTS

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

OTHER PARTICIPANTS

Stephen Kim

Analyst, Evercore ISI

Michael Rehaut

Analyst, JPMorgan Securities LLC

Rafe Jadrosich

Analyst, BofA Securities, Inc.

John Lovallo

Analyst, UBS Securities LLC

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Truman Patterson

Analyst, Wolfe Research LLC

Mike Dahl

Analyst, RBC Capital Markets LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and welcome to the Toll Brothers First Quarter Earnings Conference Call. All participants will be in listen-only mode. [Operator Instructions] The company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourself to one question and one follow-up. Please note this event is being recorded.

I'd now like to turn the conference over to Douglas Yearley, CEO. Please go ahead.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Keith. 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.

I'm very pleased with the strong first quarter results. We exceeded the midpoint of our guidance on all key metrics, and we have seen a meaningful uptick in demand that started in January and has continued through this past weekend.

In our first quarter, we delivered 1,826 homes and generated home building revenue of \$1.75 billion, up 3.7% in dollars compared to the first quarter of fiscal 2022. Our adjusted gross margin was 27.5%, or 50 basis points better than guidance and 190 basis points better than last year's first quarter.

SG&A expense at 12.1% of home building revenues was significantly better than both last year's first quarter and our guidance, as we are benefiting from cost savings initiatives that we've implemented over the past year. Moving forward, we will continue to execute on additional cost-saving plans to further reduce SG&A expense.

Pre-tax income was \$253.8 million, and earnings per share was \$1.70 diluted, up 26% and 37%, respectively, compared to last year's first quarter. At first quarter end, our backlog stood at \$8.6 billion and 7,733 homes. Although we've seen orders decline 50% to 60% on a unit basis over the past three quarters, backlog is down only 21% in dollars compared to one year ago. As a result, we continue to expect solid results this year, and we are reaffirming our full fiscal year 2023 guidance of an adjusted gross margin of 27% and \$8 to \$9 of diluted earnings per share.

Turning to the sales environment, we are encouraged by what we have seen across our footprint over the past 1.5 months. Beginning in the first week of January, demand has picked up beyond the normal seasonality that we typically see at the start of the spring selling season and has continued into February. We've seen demand improve in most markets across the country, including Florida, Atlanta, South Carolina, Charlotte, DC Metro, Pennsylvania, New Jersey, Texas, Colorado and Southern California.

Over the past few weeks, we have also seen signs that demand is improving in markets that struggled the most in the second half of 2022, such as Boise, Phoenix, Reno, Las Vegas and Austin. We attribute the increase in demand to improve buyer sentiment, as inflation appears to be receding and the overall economic outlook seems to be more stable than it was a few months ago.

Over the past decade, the housing market has been driven by 75 million millennials entering their prime home buying years. Baby boomers who have been buying homes as they retire and adopt new lifestyles and migration trends that have favored the Sunshine and Mountain states.

At the same time, the US has chronically underproduced new homes. Study after study has shown that home starts have not kept up with household formations for many years. And as a result, there now exists a deficit of anywhere between 3 million and 6 million homes in this country.

This supply shortage was obvious during the pandemic when buyer urgency surged, demand spiked and prices rapidly increased. It was less obvious in the second half of 2022 when the impact of the sharp and rapid increase in mortgage rates caused many prospective buyers to put their searches on pause.

Now, however, with the traditional spring selling season upon us and consumer confidence improving, buyers are coming off the sidelines. The most telling sign that these fundamentals are real and meaningful is the fact that rates didn't have to go back to 3.5% or even 5.5% for buyers to come back out. In fact, this past week, we had the most deposits we have seen in a month even though rates had moved back up over 6.5%.

The improvement in demand is playing well into the strategy we outlined on our December call, in the second half of fiscal 2022 with demand inelastic in many markets, that is buyers were not all that moved by price concessions. And with extended delivery times and elevated building costs, we chose not to chase the market down. Instead, we focused on delivering our large high-margin backlog, while taking a more patient and balanced approach to new sales and waiting for what we believed would be a better spring selling season.

We are now replenishing our supply of spec homes and increasing community count into the spring selling season, taking advantage of improving supply chains and cycle times and building costs that are stabilizing, all while demand appears to be rebounding. As we execute on this strategy, we continue to make appropriate adjustments to product, price and incentives at each of our communities based on a detailed assessment of local market dynamics, including elasticity of demand, the size of each community's backlog and the depth and quality of our land holdings in the market.

In our first quarter, about two-thirds of the \$117,000 sequential decline in the average sales price of new contracts was attributable to mix. The remaining one-third was due to increased incentives leading to a first quarter average incentive of about 8%. Today's incentive on the next home sold is about 6.5%. Historically, our average incentive has been approximately 3% over the past 15 years. Based on the recent strength in the market, we expect to continue to pull back on incentives in select communities.

With the retail market type and buyers eager to lock their mortgages at contract and move more quickly into their new homes, demand for spec homes has been very strong. For the past several quarters, approximately one half of our orders were for specs, which we have sold at various stages of construction. Please remember that we define a spec as any unsold home with at least a foundation in the ground.

Considering current market conditions, we are strategically starting more spec homes in select markets, but most will be sold early enough in the construction cycle, so the buyer will still have the opportunity to personalize their finishes, which is very important to our luxury buyers.

We are also pleased that our cancellations have remained low. Cancellations in the first quarter totaled 244, down from the 312 cancellations we recorded in the fourth quarter. As a percentage of backlog, cancellations were 3% versus our long-term average of approximately 2.3%. Our low cancellation rates speak to the financial strength of our buyers, the sizable deposits they make and how emotionally invested they become as they personalize their new Toll homes.

While we are encouraged that buyers are returning to the market, we recognize that the direction of the overall economy, mortgage rates and housing market remains unclear. In light of this uncertainty, we plan to remain prudent as we invest in the growth of our business through disciplined and capital-efficient land buying. We have sufficient land in our existing portfolio to support community count growth in both, fiscal 2023 and 2024, which allows us to be highly selective as we assess new land opportunities and takedowns under existing options.

At the end of our first quarter, we owned or controlled approximately 71,300 lots versus 76,000 lots at the end of our 2022 fourth quarter, and 86,500 lots one year ago. 52% of our 2023 first quarter end lots were owned and 48% were controlled through options. Excluding the lots in backlog, 54% of our total lots were controlled through options.

We continue to expect to generate substantial cash flow in 2023, and we have ample liquidity under our credit facilities. We intend to use excess cash to further reduce leverage and return capital to our shareholders.

With that, I will turn it over to Marty.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. We are pleased with our first quarter results. We grew both our top and bottom lines and operated more efficiently compared to last year.

First quarter net income was \$191.5 million, or \$1.70 per share diluted, up 26% and 37%, respectively, compared to \$151.9 million and \$1.24 per share diluted a year ago. Our net income and earnings per share were both first quarter records.

We delivered 1,826 homes and generated home building revenues of \$1.75 billion. The average price of homes delivered in the quarter was \$958,000. We signed 1,461 net agreements in the quarter, down 50% compared to the first quarter of fiscal year 2022. However, demand improved each month as the quarter progressed. In fact, our January 2023 net agreements exceeded both November and December combined.

As Doug mentioned earlier, February continues to show strength through this past weekend. The average price of contracts signed in the quarter was approximately \$995,000. This was down approximately 3% year-over-year and 11% on a sequential basis. As Doug mentioned, two-thirds of this sequential decline was simply mix.

Our first quarter adjusted gross margin was 27.5%, up 190 basis points compared to the 25.6% in the first quarter of 2022. Gross margin exceeded our guidance due to good cost control and less than expected incentives in our deliveries.

Write-offs in our home sales gross margin totaled \$8 million in the quarter. Approximately \$3 million of this was related to walk away costs on 4,100 option lots that we decided not to buy and the balance was related to one operating community in the state of Washington.

SG&A as a percentage of revenue was 12.1% in the first quarter, compared to 13.4% in the same quarter one year ago. Note that our SG&A expense in the first quarter always includes accelerated stock compensation expense. It was \$12 million this quarter compared to \$10 million last year. This is an annual expense that only hits in the first quarter.

The year-over-year 130 basis point reduction in SG&A margin reflects leverage from increased revenues as well as benefits from tighter cost controls. Total SG&A expense declined \$15 million in the quarter, compared to Q1 of 2022.

With this improved operating efficiency, we are lowering our projected SG&A expense as a percentage of home building revenue for the full year by 30 basis points. We now expect the full year 2023 SG&A margin of 11%.

Joint venture, land sales and other income was \$16.8 million during the first quarter, compared to \$29.9 million in the first quarter of fiscal year 2022. We exceeded our guidance by approximately \$7 million even after a \$13 million impairment to mark down land we intend to sell to its fair value.

We ended the first quarter with \$2.6 billion of liquidity, including approximately \$790 million of cash and \$1.8 billion of availability under our revolving bank credit facility. Last week, we extended our 22 bank \$1.905 billion revolving credit facility out five years to February of 2028.

We also extended the maturity of \$487.5 million of our \$650 million term loan out to February of 2028. The remaining \$162.5 million of our term loan will mature in part in November of 2025 and November of 2026. Importantly, \$400 million of our \$650 million term loan has been hedged through November of 2025 with interest rate swaps that are fixed at approximately 1.5%.

Our net debt-to-capital ratio was 27.5% at first quarter end, down from 31.9% one year ago. We plan to further reduce our debt by repaying \$400 million of senior notes when they come due in April of 2023. After we repay these notes, we will have no significant maturities of our long-term debt until fiscal 2026.

Our book value per share at quarter end was \$55.98, and I'll remind you that we have almost no intangibles on our balance sheet. In the first quarter of fiscal 2023, we returned \$32 million to shareholders through share repurchases and dividends. We continue to target \$400 million of annual share repurchases, and we continue to pay a quarterly dividend of \$0.20 per share.

Our community count at quarter end was 328 compared to our guide at 340. The variance from our guide was almost entirely due to selling out 11 communities faster than we anticipated. Our openings generally met our plan. Our forward guidance is subject to the usual caveats regarding forward-looking information. That being said, the 7,733 homes in backlog at first quarter end gives us good visibility for the remainder of the year.

We are projecting fiscal 2023 second quarter deliveries of approximately 2,050 to 2,150 homes with an average delivered price of between \$980,000 and \$1 million. For fiscal year 2023, we are maintaining our guidance and project deliveries of between 8,000 and 9,000 homes with an average price between \$965,000 and \$985,000.

We expect our adjusted gross margin in the second quarter of fiscal year 2023 and for the full year to be approximately 27%. We expect interest in cost of sales to be approximately 1.5% in the second quarter and for the full year. This would represent a 20 basis point reduction in interest expense and cost of sales year-over-year as our leverage continues to decline. We project second quarter SG&A, as a percentage of home sales revenues, to be approximately 11.2%. And as I mentioned, for the full year, we now expect it to be 11.0%.

Other income, income from unconsolidated entities and land sales gross profit is expected to be approximately breakeven in the second quarter and \$125 million for the full year. Much of this full year other income is projected from second half sales of our interest in certain stabilized department communities developed by Toll Brothers Apartment Living in joint venture with various partners. While the market for the sale of these stabilized rental properties is unpredictable due to volatility in the capital markets, our occupancies remain strong and we do currently expect to sell our interest in four of these joint ventures by the end of the fiscal year.

We project the second quarter tax rate at approximately 26% and a full year tax rate at 25.7%. Our weighted average share count is expected to be approximately 112 million shares for the second quarter and 111 million shares for the full 2023 fiscal year. This assumes we repurchased a targeted \$100 million of common stock for the second quarter and \$400 million for the year. Putting this all together, that works out to be between \$8 and \$9 per share for the full year, which would move our book value above \$60 at fiscal year-end 2023.

Lastly, as Doug mentioned, we expect to continue generating strong cash flow in 2023 and we remain cautious on new land spend. But based on the land we currently own or control, we continue to expect community count to grow by 10% by the end of fiscal year 2023. This would be off the base of 348 communities that we started the year with. We also control enough land to grow community count in fiscal year 2024.

Now let me turn it back to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. Earlier this month, Fortune Magazine named us the #1 World's Most Admired home building company. This is the eighth time we have received this honor. I would like to thank all of our Toll Brothers team members for achieving this tremendous recognition. They continue to demonstrate their dedication to our brand and to our customers. And for that, I'm very grateful. I'm so proud of our team and of our company.

With that, Keith, let's open it up to questions.

QUESTION AND ANSWER SECTION

Operator: Yes. Thank you. We will now begin the question-and-answer session. [Operator Instructions] And the first question comes from Stephen Kim with Evercore ISI.

Stephen Kim

Analyst, Evercore ISI

Q

Thanks very much guys. Thanks for all the great color here. Obviously, it seems like the tone of your demand has stayed strong. So, I'm not going to ask about that, probably others will, but it's very encouraging. I was curious about your customer acquisition costs. This environment we've been living through over the last couple of years has been so unusual. But as you look forward with a market that potentially is normalizing, can you give us a sense for what your customer acquisition costs look like relative to, let's say, what it was like pre-pandemic. I'm thinking things like external broker fees and maybe increased use of the Internet to attract incremental customers, to give us a sense for where your SG&A margin is likely to trend over the next couple of years?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. It's a great question, Stephen. The money we spend is 99% digital today. You won't find Toll Brothers on the TV, on the radio or in the Sunday paper and it's become more and more efficient, as we've gotten better and better at how we target clients through digital means. We're very proud of our website. We have an internal web team, that's all they do. And we get lots of compliments from our clients on their ability to navigate on our website to try to find the homes that they want.

And so, I think we will continue to become more and more efficient with the dollar spend when it comes to the digital marketing, which is so important to us. The biggest expense, of course, is brokers, realtors and we have been comforted and happy to see the realtor engagement involvement with the client is coming down.

Back 5, 10 years ago, as you know, we were running about 60% of our sales had a realtor, and that number today is down around 40%. You could argue a year ago when we were on allocation and we sort of had clients lined up, that you had more clients that were coming in without the realtor because they were just waiting in line for their opportunity.

But in today's market, for that number to be down around 40%, we're very encouraged. And we're hearing from the client that with the resale markets being tight, they are moving faster or exclusively to new homes and they're able to go on our website to learn everything they need to learn where they are confident and comfortable that they can buy on their own without the broker.

So, the realtor community is important to us. We support that community. We know we need them, but it is a significant expense, and it has come down. We're going to have to wait a few quarters to see if this is a pretty longer term, permanent change to the business. But for the last couple of quarters, it's been down at that 40% range at a time when you wouldn't think it would be down. So, for that, we are encouraged, and I think we're going to get more and more efficient on the S of the SG&A.

Stephen Kim

Analyst, Evercore ISI

Q

Got you. That's helpful. I wanted to also ask about the difference you're seeing in, let's call it, your afflux or affordable luxury customer versus your more traditional luxury customer. As it relates to your comments about incentives, I think that you had talked about incentives actually running at 6.5% today versus 8% in the past quarter, which would imply obviously that things are getting better.

I wanted to understand, is that reduction in the incentive due primarily to the fact that the mortgage rate buy down is not costing you as much just because the prevailing market rate has come down? Or is that actually due to actions, proactive actions on your part to not have to – to not offer significant incentives? And is there a difference between what you're seeing in the incentive trend at the lower – not low end, but affordable luxury end versus the traditional luxury end?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, let's start with sales. The sales cadence between affordable luxury luxury and what we call empty nester active adult, which is [audio gap] (00:28:34), for the first quarter it was the same. We were down 50%, as we mentioned, and each of those segments was virtually identical. So, they're all performing about the same.

When it comes to the [audio gap] (00:28:51), it is slightly higher on the age restricted than it is on the affordable luxury, and it is quite significantly lower on the true luxury, our bread and butter. So, let's just pick a number of 8% to go back to the first quarter. Age-targeted, age-restricted ran about 8.5%, affordable luxury ran about 8% and the luxury ran around 4%-ish, in that range. The luxury client is wealthier. They're less impacted by rate. It's just a different buyer, as we talked about, for many, many years. And we think we've had that advantage in a volatile rate market.

With respect to what we're doing with incentives, the increase in demand in January and now into February, when we look back on it, it was partially driven by us increasing some incentives, as I mentioned in the prepared comments. As we saw demand become more elastic, we could incentivize a little more and see good results. But we think it is more driven by buyer sentiment, by the seasonality, by people coming back out, they absorbed – they were able to absorb the higher rate and they wanted to buy.

And when they went out to the market, they realized the resale market is so tight, there's no opportunity, and they came to us, and they started hearing our salespeople talk about significant increase in traffic. The boss saying, I may be raising prices or dropping incentives, and there became this sense of urgency with the client that, oh, boy, it sure sounds like we're off the bottom and I don't want to miss this opportunity even though, yes, the rate is higher, it sounds like Toll Brothers may be raising some prices or dropping some incentives.

And that urgency was created, and it's real. We are dropping incentives. We are raising prices. We're doing it selectively, we're doing it surgically, but it's happening throughout the country, which is one of the reasons why I explained in my prepared comments that the – today's incentive is less than it was back in December, and we

think that's going to continue to go down. So, that's the market environment. That's the breakdown between our product mix. I hope I helped you.

Operator: Thank you. And the next question comes from Michael Rehaut with JPMorgan.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Thanks. Good morning, everyone.

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Good morning, Mike.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

I know there's a lot of discussion. You just kind of alluded to some things around buyer confidence versus interest rates. And it's obviously very interesting that you're saying the strongest sales weekend has been this past and that obviously, after a pretty tumultuous February so far. I guess the question is, obviously, sometimes it takes a little bit of time for a move-in rates to have its impact into the marketplace. The MBA purchase app index was down pretty sharply this morning.

Q

So just wanted to get your take, as you've seen the volatility in rates over the past six months, six, seven months, how you view this most recent move, and obviously, it's a pretty encouraging data point over this past weekend. But how do you put into context this most recent move over the past month. And does it kind of create any concerns or anything in terms of traffic over the last few weeks that might make you concerned as you saw a lot of volatility, obviously, over the last two or three quarters?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. So, Mike, if you'd ask me, Doug, if the rate goes from 7.375% to 6.25%, are these buyers going to be rolling back in? I honestly would have told, yeah, I don't know. I don't think – I don't know if that's enough. And they did. And then when you asked me, Doug, in a two-week period of time when the REITs go from 6.25% to 6.75%, what's that going to do? I tell you the truth. I'd be worried. And it's not that I'm not worried. You're right, it's only one week. We've had rates go up now for two weeks, and we've had two good weeks with this last week being the better of the two. Now the prior week was a Super Bowl week which isn't – historically isn't quite as strong as the week following the Super Bowl, which is what we're now in.

A

So it's too early to be running around here with a lot of high-5s. I get that. But it is very encouraging that buyers came back out at 6.25%. It didn't take 5.5%. It didn't take 4.99%. It certainly didn't take the old – the good old days of a year ago of 3%. That was really encouraging, and it's even more encouraging with a very short timeframe data point that as those rates moved from that 6.25% to 6.75%, they're still out. Traffic is really good. Web activity is really good. We have continued to create urgency in the sales center because we are dropping incentives. We are raising prices and the buyers are out.

But I'm not going to sit here and tell you that that we're out of the woods. We understand the volatility to rates. We understand the clouds over the economy. They haven't all cleared yet. It's looking better, inflation is coming down, the Fed seems to be doing their job, but the stock markets until the last few weeks have performed well. Our

buyers are less impacted by rates for all the reasons we've been talking about, back to Bob Toll used to talk about it 25 years ago. But we're encouraged by the recent activity. That's the best I can tell you, and it's happening in the 6.5%-plus rate environment.

Remember that the 10-year – the spread from the 10-year to 30 years, 300 points. Historically, it runs in the high-100s. So if that spread does tighten to more historical norms, we're going to be in good shape. And the buyer doesn't have a mentality of I'm locked into this 6.5% rate for 30 years.

Refi happens all the time. Our buyers are sophisticated. Most of them have owned homes before. Almost all of them have refied in their life. They know for \$2,000, \$3,000, \$4,000, they can get out of a higher rate and jump into a low rate, and there's also that mentality. They want to move on with their lives. They took eight months off. They're now sensing some urgency, and they're back. And I'm not saying rates aren't important, and they don't impact affordability, they do. But for our business model, it is not the number one thing.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, no, no, I appreciate those comments, Doug. And certainly, a lot of it makes sense, particularly on the refi side. I guess, secondly, just wanted to make sure I heard right from the prior question. The decline in average incentives going from 8% to currently 6.5%, I just missed if that was driven by actual outright incentive reductions or the cost of the mortgage rate buydowns being less expensive, and more broadly – sorry?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

It's incentives. It's not a difference in buydown rates.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Okay. Well, the heart of the question, though was, looking at the guidance, you took down SG&A due to some progress on cost saves. The gross margin, though, I'm curious if that was more based on the 8% average incentive and if you continue to have 6.5% or potentially even lower, could that ultimately drive some upside in your gross margin guidance for the full year? I think you said that the upside in the first quarter was due to less incentives as well.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yeah. Mike, it's Marty. Thanks for your questions. We expect our gross margin to be relatively consistent through the balance of the year to get to that 27% for the year. There's estimates in that, obviously, with respect to what's in the backlog and what may be sold and settled in the interim. But we feel like we've accounted for the puts and takes that we showed in the guidance we've given you.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And part of that, Mike, there is a budget in place as part of that guidance for that occasional need to work with some of the backlog to get them to close. But we've been very pleased with how low that can rate is and how little we have had to spend with that backlog.

Operator: Thank you. And the next question comes from Rafe Jadrosich from Bank of America.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Hi. Good morning. It's Rafe. Thanks for taking my question.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Absolutely.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Just first, the net debt to cap is already kind of at the low end of your historical range. Can you just talk about the right level you're thinking about going forward? And then with the market improving a little bit here and supply chains improving, you're going to generate a lot of cash. So how do you think about land spend versus buybacks going forward?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

With respect to the net debt to cap, I think we're comfortable with the gross level in the high-20s, and a net level in the mid-20s that's consistent with our discussions with the rating agencies. It may fluctuate a little bit around those numbers based on timing of maturities. With respect to new land and debt paydowns and stock repurchases as it relates to capital allocation, it's a delicate balance. And we are fortunate based on our financial flexibility to do a little bit of all of those.

Right now, the deal flow for land has to hit a much higher underwriting threshold and has been a little bit less. There are plenty of deals in our pipeline that meet those thresholds, particularly those that were underwritten a number of years ago, and we continue to execute on those. And we have \$400 million of debt that we'll be paying off in the second quarter here, while we continue to buy land and buy stock back.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And I would point out that over the last five quarters, we have walked away from 14,000 option lots. Part of our strategy a few years ago to get more capital efficient and have less risk in our landholdings was to option more land. And as you've seen by the modest walkaway costs that we've had over those five quarters, it's been pretty painless to walk away from those lots because in today's environment, they weren't working. Now that will be replenished at the right price and also with capital-efficient strategies. But I think it shows – it's the payoff of being very capital efficient and selective in how we've been buying land that we can walk away from that number of options painlessly.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Thank you. That's helpful. And then in the gross margin guidance, can you talk about sort of the underlying assumptions or just what you're seeing in terms of construction costs going forward here? For example, can you talk about maybe for a house that started today, what's the construction cost that you would anticipate versus a

similar house three months ago? Like have you started to see that come down? And what type of tailwind can we expect from a margin perspective there?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. The – so let's start. Supply chain is improving. Cycle time is improving as contractors have more capacity. And costs have stabilized, except for lumber, which is our biggest material cost, has come down significantly. So there's a very nice tailwind with lumber. It's flattened out in the last month or so, six weeks maybe. But before that, it was coming down pretty rapidly every week. We do believe, as the year progresses that there will be other costs, both labor and materials, that will be coming down. But right now, costs are stabilized, except for lumber, which is a nice tailwind.

So, stay tuned for the balance of the year. We are actively talking to trades, the normal conversation is the trade that didn't have capacity now comes and says, hey, I've got an extra framing crew or two that could use some work. That is the opening to get a price concession. And so that is the beginning of the process of seeing costs come down.

Operator: Thank you. And the next question comes from John Lovallo with UBS.

John Lovallo

Analyst, UBS Securities LLC

Q

Hi, guys. Thank you for taking my questions as well. The first one is on just going back to SG&A, down \$15 million year-over-year on a similar revenue base. And I know you talked about broker commissions and a few other things, Doug. But what are some of the more structural cost-saving plans that you guys have been successful with?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Headcount. We're trimming the firm. We're learning how to be more efficient with less people. As we have retirements, we're replacing from within, we're promoting from within, without needing another person. We've gone through a very difficult, thoughtful round of cuts in the last 30 days. We have a plan to become even more efficient with head count and some other initiatives in the firm, but it's primarily head count.

John Lovallo

Analyst, UBS Securities LLC

Q

Got it. Maybe if I could just follow-up on that. Is there a risk that you're going to negatively impact growth if things were to pick up here, given those head count reductions?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

No.

John Lovallo

Analyst, UBS Securities LLC

Q

Okay. Okay, great. And then second question is, just digging into buyer mentality and psyche here, which is pretty interesting, I mean, it looks like there was a slight step-up in cash buyers quarter-over-quarter, at least as a

percentage. And you mentioned some fear of missing out, maybe more confidence. But in general, from what you're hearing, do you think folks are just getting more accustomed to higher interest rates?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. So, cash went from 20% of our buyers to 23%, that we expected. It's common sense, right? As rates go up, if you can afford to write the check, you write the check. But I do believe, as we thought, it would take some time for the buyers to adjust to a higher rate environment. And that's exactly what happened. It happened back for the mid-1990s to the mid-2000s, which was good market. We were at 6% plus mortgage rate environment. It's been many years since we've been there, and now we're back there and it took some time.

And I think that's the primary – we have great fundamentals. I know I went through them, the migration trends, the demographics with millennials and boomers, the pent-up demand, a tight resale market, 3 million to 6 million too few homes in this country, that big demand/supply imbalance that's been there for a decade. All of that can't be ignored. And as the buyer took a pause and absorbed the higher rate, it appears they're coming back out. That's what we've seen over the last seven weeks.

Operator: Thank you. And the next question comes from Susan Maklari of Goldman Sachs.

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Q

Thank you. Good morning, everyone. My first question is around the commentary that you gave of increasing your spec construction just given that people are looking for quick move-in homes. Can you give a bit more detail on the number of specs you have and how you're thinking about adding supply as we go further into the spring?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, Susan, our model right now, we have about 2,200 specs, to answer your question. And those are – again, we define a spec as foundation or beyond. And we sell a lot of these with enough time left for the client to pick finishes, so they can get kitchen cabinets and countertops and flooring and some of the other fancy things that we show up in our design studios.

Our business model right now is to be about 30% to 35% spec, which means we will be starting more homes without a buyer. So, we're not holding them up off the market. But that's the business model at the moment. It's obviously market-dependent, community-dependent based upon local dynamics, but that is what we are targeting.

And I'm very comforted when I look at those 2,200 specs and where they are spread between permit and foundation and framing and finishes and complete, because we break all that down, it's a really good mix. So, when the client comes in, they want a house in 60 days, we may very well have it. If they want in four months and they want to fix some finishes, we may very well have it. It's really nicely spread.

So, what we're talking about is the cadence of the starts of the new specs to continue to fill in as we sell what we have. And we have a very detailed plan in place, but it should get to about that 30% this year.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Susan, I think it's – and Doug hinted at this, but it's a very carefully managed process as to how many specs to start based on what you just sold, what stage of construction other units are in. And so, we've developed some pretty sophisticated ways looking at this by market, by community, by stage of construction, by pace of sales.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah.

Susan Maklari

Analyst, Goldman Sachs & Co. LLC

Q

And given the guide and the commentary, is it fair to assume that the margin that you're realizing on those specs is not materially different than what you're getting on the core product?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So through COVID, specs generated a higher margin because people were paying a premium to get into a home quickly. From the summer through the end of the year, specs were getting a lower margin than to-be-built because the market was a lot softer as buyers were on the sideline. And now we are trimming the incentives on specs faster than the to-be-built.

And so that's a long answer to say, yes, today, the margin between spec and to be built has narrowed. And we think if this demand for specs continues, we're going to get back to having the spec margin be a bit higher, but we're not there yet, but it is beginning to trend in that direction.

Operator: Thank you. And the next question comes from Truman Patterson with Wolfe Research.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Hey, good morning, guys. Thanks for taking my questions.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Good morning, Truman.

Truman Patterson

Analyst, Wolfe Research LLC

Q

First, I'm just hoping to get perhaps a clean number on orders pricing because a couple of quarters ago, you think there was an accounting and mix issue in the order ASP. And I understand that incentives have reduced recently, but sometimes incentives can turn into base price cuts, et cetera. So I'm trying to understand what core pricing might be down from peak between base price cuts and just all in incentives?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Well, we tried to address that in our comment that one-third of the price difference this quarter versus last quarter was associated with incentives. So call that \$35,000 to \$40,000.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Which is also base price drop.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Yeah.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

It's all one bucket.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right.

A

Truman Patterson

Analyst, Wolfe Research LLC

Okay. Got you. Okay. So that's kind of an all-in number that you all gave, perfect. And then, over the past decade or so, you all have had some pretty nice geographical expansion from mid-Atlantic, Northeast, out west and south, et cetera. I'm trying to understand, given the softness in the market, the recession that we've just gone through, are there any areas that you might find some land opportunities or geographical areas that you're targeting to expand to in the coming years?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

We've expanded quite a bit in the last three or four years. We went into San Antonio. We went into Tampa. We've gone to Portland, Oregon. We've gone to Salt Lake City. We went to Spokane-Coeur d'Alene. And so at the moment, Truman, there are – we're going to Long Island. We just opened in Long Island. Thank you, Marty.

A

So at the moment, there's no hot new market that we have our eyes on that we're far enough along to tell you that we think we're going. We're always looking. I think we're most focused, however, on getting bigger and more diversified in the existing core markets where we're operating really well.

That's also going to really help leveraging the SG&A, because some of these smaller market startups are pretty inefficient for a number of years before you get the machine going. And so I think over the next couple of years, you'll see less of the secondary, tertiary market expansion and more growth in our core markets.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

The one market you didn't mention is Nashville, where we do have expense and we don't have any communities open yet.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right.

A

Operator: Thank you. And the next question comes from Mike Dahl with RBC Capital Markets.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Good morning. Thanks for fitting me in. Just a follow up on the orders environment. It was helpful in terms of the color on January being greater than November, December combined. So I guess high-level math would be January had to be at least around 750 orders compared to 350, give or take in November, December. But could you put a finer point and just help walk us through the monthly trends? And then when you talk about the February improvement, if you can give us some sense of quantification on orders, not just deposits?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

All right. I got it right here. So November was down 72% year-over-year. December was down 55% year-over-year. January was down 31% year-over-year. January sales were the highest pre-January 2020 since January of 2005. February is the same as January.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. That's very helpful. Thank you. Feb, when you say same as January, in unit terms or a percent change?

[indiscernible] (00:54:40)

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Units. Yeah.

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Okay. Thank you. My follow up question, just on the land side, I mean, you guys obviously tightened up your underwriting quite a bit. You've given some high-level metrics in terms of combined margin and IRR thresholds in the past. Where do those stand now? Have you maintained the similar threshold? Have you shifted that threshold at all up or down based on what you're seeing?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

We've kept it the same, which is – we used to be 55% combined gross margin IRR to buy ground. That went to 60%, it's now 65%. So if you're going to have a 25% gross margin, you're going to need a 40% IRR. If you're going to have a 30% gross margin, we'll give you a 35% IRR. It's tight. It's hard to find deals. We have deal flow, it's happening, but we are being very disciplined right now in that very high combined underwriting.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

And we're using current paces.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

In other years, we might have had a 12-month pace put in front of us. And we say that 12 months don't matter. We need to see what happened over the last four weeks, eight weeks kind of pace because that should – that's what you should annualize not the full 12 months.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Right. Now as cycle times come down, as some building costs come down, the teams are allowed to plug-in current conditions for that too, but they have to work off of current market conditions when it comes to sales price and sales pace. So we have some frustrated land teams out there, but that's good. They're hustling and we celebrate deals. We're doing deals and we make sure everybody knows that the treasury is open. It's just tight.

A

Operator: Thank you. And this concludes our question-and-answer session. I would like to turn the conference back over to management for any closing comments.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you very much. Thanks, everyone, for your interest and support. We appreciate very much. We're always here to answer any individual questions you may have. And – what is it 6 PM in Philly today, so spring is coming. Thanks so much. Take care.

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

Disclaimer

The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2023 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.