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Toll Brothers, Inc. (TOL)

Q4 2023 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Toll Brothers Fourth Quarter Fiscal Year 2023 Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] The company is planning to end the call at 9.30 when the market opens. During the Q&A, please limit yourself to one question and one follow-up. Please also note this event is being recorded.

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

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Rocco. Good morning. Welcome and thank all of you 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.

Fiscal 2023 and the fourth quarter were terrific for Toll Brothers. Our income and earnings per share for the full year were all-time highs, and we ended the year with a 72% increase in fourth quarter signed contracts compared to Q4 2022.

We delivered 2,755 homes and generated \$2.95 billion in home sales revenues in the fourth quarter, \$211 million above the midpoint of our guidance. Our adjusted gross margin was 29.1% and our SG&A expense as a percentage of home sales revenues was 8.2%, each beating guidance by 60 basis points. The combination of top line outperformance and improved operating efficiency resulted in net income of \$445.5 million or \$4.11 per diluted share, our second best fourth quarter ever behind only last year's fourth quarter.

For the full year, we delivered 9,597 homes at an average price of approximately \$1.030 million, generating record home building revenues of \$9.9 billion. Our full year adjusted gross margin was 28.7%, a 120 basis point increase over 2022, and 20 basis points better than guidance. SG&A expense as a percentage of home sales revenues was 9.2%, an improvement of 90 basis points compared to last year, and also 20 basis points better than guidance.

Earnings in fiscal year 2023 were \$1.4 billion, or \$12.36 per diluted share, both company records. Our book value per share was \$65.49 at year end, and our return on beginning equity was 22.8%. We accomplished these results despite mortgage rates reaching generational highs, global unrest, gridlock in Washington, and fears of a recession. Our success was due in large part to our strategies of not chasing sales at a lower margin in the second half of 2022, increasing our supply of spec homes, and focusing on operational efficiency.

Turning to market conditions, we continued to see solid demand for our homes in the fourth quarter as a tight resale market continued to drive buyers to new homes. We signed 2,038 net contracts at an average price of \$989,000, up 72% in units compared to Q4 2022. The average price was down 11% year-over-year, but essentially flat over the prior three quarters of 2023. The decline in ASP was due primarily to mix. In fact, we raised our average net price after incentives by \$16,000 in the quarter.

Remember that our mix shifts and lower ASPs should not be a surprise. It means our strategy of broadening our product offerings to include lower price points and capture greater market share, and growth opportunities is working. Along these lines, our affordable luxury and active adult communities were our strongest performers in the quarter.

Unit sales of affordable luxury homes were up 109% in Q4 2023 compared to Q4 2022, and active adult was up 82%. In Q4, affordable luxury accounted for approximately 46% of our unit sales, luxury was 31%, and active adult was 23%. On a dollar basis, affordable luxury was 38%, luxury was 43%, and active adult was 19%.

Geographically, our Pacific region was up nearly 250% in agreements in the fourth quarter versus the prior year, followed by our Mountain region which saw a 127% increase, and the South of 87%. Our strongest markets in the quarter were Denver, Boise, Southern California, all of Texas, and the Mid-Atlantic from Atlanta up the eastern seaboard to Boston.

In terms of cadence for the quarter, demand followed the typical seasonal pattern with September being the strongest for deposits. October was stronger than expected, given the rise in mortgage rates, and we were encouraged that we did not have to increase incentives to drive sales in that month.

As I mentioned, we actually raised our average price by \$16,000 in the quarter, broken down as a \$12,000 increase in base price and a \$4,000 decrease in incentives. Demand has remained solid into the start of our first

quarter and is consistent with normal seasonality. As a reminder, historically, net orders decline about 20% from our fourth to first quarter, primarily because of the holiday months of November and December fall in our first quarter.

We are anticipating a modestly better trend this year as we are encouraged by the recent 75 basis point decline in mortgage rates. With inflation easing over the past few quarters, we believe rates may drop further and the timing of the rate decline is setting up nicely for the upcoming spring selling season. This timing also plays well into our strategy of increasing our spec supply and growing our community count.

In the fourth quarter, spec homes represented approximately 42% of our orders and 33% of our deliveries. We expect that specs sold in fiscal 2024 will account for approximately 35% of deliveries in 2024. Remember that we define a spec as any home without a buyer that has foundation poured. We sell our specs at various stages of construction, which allows many of our buyers the opportunity to still personalize their homes with finishes that match their tastes.

Specs allow us to buy down mortgage rates, and we also benefit from a faster, more efficient construction schedule. The other 65% of our projected 2024 deliveries are either in our backlog, which stood at nearly 6,600 homes, and \$6.95 billion at fiscal year-end, or are built-to-order homes that have already sold, or will be sold in this first quarter. This provides a solid base of high margin homes to drive 2024 results.

We expect community count growth to also help drive results in fiscal 2024. We plan to increase community count by 10% this year, and are targeting 410 operating communities at year-end. Importantly, we control sufficient land for community count growth beyond 2024. At fiscal year-end 2023, we controlled approximately 70,700 lots, 49% of which were optioned.

Excluding the 6,578 lots committed to home buyers in our backlog, our optioned land represented 54% of lots. We continue to target an overall mix of 60% optioned and 40% owned over the longer term. We also continue to be selective and disciplined in our approach to buying land. We assess all land deals, whether they involve new land opportunities or takedowns under existing options with underwriting standards focused on both margins, and returns. This approach and our overall focus on capital efficiency has helped drive our ROE over 20% for the past two years.

In our fourth quarter, we repurchased \$326 million of our common stock, bringing our full year repurchases to \$556 million at an average price of \$72 per share. During fiscal 2023, we repurchased approximately 7% of our diluted shares outstanding at the beginning of the year. We also paid \$91 million in dividends in fiscal 2023. Buybacks and dividends will remain an important part of our capital allocation priorities well into the future. We have budgeted another \$400 million of share repurchases in fiscal 2024.

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

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Doug. As Doug mentioned, we are very pleased with our fourth quarter and full year results. Our revenue, net income and earnings per share were all full year records. In fiscal year 2023's fourth quarter, we delivered 2,755 homes and generated home sales revenues of \$2.95 billion, down 27% in homes and 18% in dollars from one year ago, reflecting the challenging sales environment from back then. The average price of homes delivered was up 13% to \$1.071 million.

Fourth quarter net income was \$445.5 million, or \$4.11 per diluted share, compared to \$640.5 million and \$5.63 per diluted share one year ago. Remember that last year's net income included a net after-tax benefit of approximately \$103 million related to the proceeds from the settlement of a legal claim.

Our fourth quarter adjusted gross margin, which excludes interest and inventory write-downs, was 29.1% in 2023, up 10 basis points compared to 29.0% in the fourth quarter of 2022, reflecting our strategy from over a year ago not to aggressively chase sales at the expense of margin when the market was softer.

SG&A as a percentage of revenues was 8.2% in the quarter compared to 7.7% in the same quarter one year ago. The year-over-year percentage increase in SG&A was primarily related to less revenue leverage. Compared to 2022, total SG&A dollars were actually down \$33 million in the quarter and \$68 million for the year, despite inflationary pressures.

Joint venture, land sales and other income was \$36 million in the fourth quarter compared to \$152.5 million in the fourth quarter of fiscal year 2022, which again included the aforementioned litigation recovery of \$141 million on a pre-tax basis. Joint venture, land sales and other income in Q4 2023 included approximately \$32 million of gains from the sale of stabilized apartment communities developed by Toll Brothers Apartment Living and held in joint venture.

Despite very challenging market conditions, we were able to sell two apartment communities at reasonable prices in the quarter, which is a testament to the quality of our apartment living communities. We expect to sell additional apartment communities this year.

Write-offs included in home sales cost of revenues totaled \$8.3 million in the quarter compared to \$22.1 million in the prior year period. Land sale write-offs were \$12.9 million related to the planned sale of a City Living land parcel into a joint venture.

In the fourth quarter, 26% of our buyers paid all cash, consistent with the 25% in the third quarter and up from our long-term average of 20%. Buyers who did take a mortgage averaged an LTV of 69% in the quarter. Our cancellation rate as a percentage of backlog was 3.4% in the fourth quarter, consistent with where this rate has been for all of 2023.

We continued to generate strong cash flow in fiscal 2023, with \$1.3 billion of cash flow from operations. We ended the fiscal year with over \$3 billion of liquidity, including \$1.3 billion of cash and \$1.8 billion available under our revolving bank credit facility, which has more than four years of duration remaining.

In fiscal year 2023, we invested \$2.3 billion in land acquisition and land development. We also returned \$653 million to shareholders through share repurchases and dividends, and reduced our senior debt by \$400 million. Over the past two years, we've returned \$1.3 billion to shareholders by repurchasing 18.9 million shares. Our net debt to capital ratio was 17.7% at fiscal year-end, and we have no significant debt maturities until fiscal 2026. Our balance sheet is in great shape.

Turning to our guidance, I'd like to remind you of the usual caveats regarding forward-looking statements. We are projecting first quarter deliveries of approximately 1,800 to 1,900 homes, with an average price of between \$985,000 and \$1,005,000.

Consistent with normal seasonal patterns, first quarter deliveries are expected to be the low point of the year, with deliveries for the full fiscal year weighted to the second half. For full fiscal year 2024, we are projecting new home deliveries of between 9,850 and 10,350 homes, with an average price between \$940,000 and \$960,000.

We expect our adjusted gross margin in the first quarter of fiscal 2024 to be 28% and for the full year to be approximately 27.9%. The slight decline in our projected gross margin for Q1 from Q4 reflects the impact of the slower sales environment in the second half of fiscal 2022 and the first quarter of fiscal 2023, as more sales from that period will be delivering in Q1 than delivered in Q4.

We expect interest in cost of sales to be approximately 1.4% in the first quarter and for the full year. This reflects the continuing benefit of our lower leverage.

We project first quarter SG&A as a percentage of home sales revenues to be approximately 12.4% versus 12.1% one year ago. Included in first quarter SG&A is about \$12 million of our annual accelerated stock compensation expense that should not recur in the remainder of the year's quarters.

For the full year, we project SG&A as a percentage of home sales revenues to be approximately 9.9%. The year-over-year projected increases in SG&A margin is due primarily to the impacts of lower revenue leverage, community count growth and cost inflation. We continue to focus on cost control and operating efficiency. We've made a lot of progress, but we are not done and are working to achieve additional cost savings in fiscal 2024 and beyond.

Other income, income from unconsolidated entities and land sales gross profit is expected to be a loss of \$10 million in the first quarter, but a gain of \$125 million for the full year, which includes the sale of stabilized apartment communities. We do not expect any sales in the first quarter, but expect to sell a number of our communities by the end of the year.

We project a first quarter and full year tax rate of approximately 26%. Our weighted average share count is expected to be approximately 106 million for the first quarter and 104 million for the full year. This assumes we repurchase a targeted \$400 million of common stock this year, with most of that occurring later in the year, aligned with our anticipated higher cash flow.

Based on land we currently own or control, we expect to grow community count by 10% by the end of fiscal 2024. Putting this all together, we project approximately \$12 to \$12.50 of earnings per share for the full year, which would move our book value to approximately \$78 per share at fiscal year-end 2024.

With that, I'll turn it back over to Doug.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Marty. Two years ago, in December 2021, the 30-year mortgage rate was around 3%. It doubled to 6% in December 2022, and a little over a month ago, it broke through 8%. It's extraordinary to think that mortgage rates have moved from 3% to 8% in two years, and yet during that time, we produced two consecutive years of record revenues and earnings with ROEs above 20%.

We also increased our adjusted gross margin by 370 basis points, decreased our SG&A margin by 170 basis points, and today we are projecting another year of earnings above \$12 per share. And we are not the only ones

to have achieved strong results in the face of rising rates. It is clear the business model of the public builders has fundamentally changed.

We have grown revenues and gained market share, lowered leverage, de-risked balance sheets with a focus on capital efficiency, cash flows and ROE, and returned a substantial amount of capital to our investors. Today, Toll Brothers trades at approximately 7 times earnings and 1.3 times book value. The average PE multiple for the equally weighted S&P 500 is about 16 times. In my opinion, our valuations deserve a fresh look.

Before we open it up to questions, I'd like to thank the entire Toll Brothers team for staying focused on our customers, adapting to market conditions, and consistently executing on our core strategies. Most importantly, you've helped position the company for continued success in 2024 and beyond. For that, I am truly grateful.

Now, let's open it up to questions. Rocco, we're ready to go.

QUESTION AND ANSWER SECTION

Operator: Yes, sir. We will now begin the question-and-answer session. As a reminder, 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. [Operator Instructions] And today's first question comes from Stephen Kim with Evercore. Please go ahead.

Stephen Kim

Analyst, Evercore ISI

Q

Yeah. Thanks very much, guys. Appreciate all the color. Congrats on the good results. I guess my first question is related to your ongoing product mix shift, the affordable luxury in particular. I was curious if you could give us a sense for how long do you think this process of sort of adjusting your mix is going to take? Is this something that we could see stabilize by year-end 2024? Do you think you will have gotten your mix sort of where you want it or is it going to be something that's going to be a multiyear process? And can you help us understand what an expected range of absorptions should be, sales per community per month, once your mix does stabilize at the levels that you – at the sort of percentages that you want?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. It's a fluid process, Steve. We're really proud of this move we made into some lower price, still affordable – excuse me, still luxury product. As I've talked about, with 75 million millennials out there, we were not going to wait for them to hit their 40s and buy their move up home, which is what Toll Brothers has always been about.

And I'm really proud of how we brought the 3 Series BMW in and we went after the more affluent first-time buyer. I think it'll stabilize around 45% of our business on a unit basis. Now, remember, because the price is a bit lower, on a dollar value, that may be down five points or so from that 45%. And based on the numbers we just gave you for where we are right now, we're getting pretty close to that.

In the fourth quarter, we were spot on with affordable luxury being 46% of our unit sales, and it reflected about 38% of our dollar value. So it's fluid. We continue to focus on more and more of those opportunities, but we're getting close to what I think is a good mix. Quarter-by-quarter, it may vary a little bit, but we're about there. And as

I also mentioned, the affordable luxury and the active adult empty nester, which also tends to be a bit lower priced, naturally, they led in order growth fourth quarter 2023 over 2022.

So, the strategy's paying off, those segments are performing well, and they should, right? 75 million millennials and 75 million boomers are driving the most action in those two segments for us. So, we're getting close to where we want to be with a little bit of fluidity as it moves quarter-to-quarter, but most of the hard work is behind us.

Stephen Kim

Analyst, Evercore ISI

Q

And absorptions?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thank you. So, the last couple of years, we've been running at 24, 25 sales per community per year for the company. I think heading into 2024, particularly with rates moving down, economic outlooks beginning to improve, a sense that the Fed is done or very close to being done, we believe we're going to do better than that 24 to 25 overall for the company. And, of course, we have higher absorptions in both affordable luxury and active adult move down because the price point is lower. There're more buyers with those demographics. So let's just say if the average is 26 for the company, maybe affordable luxury, active adult is pushing up to 30 and move-ups is in, call it, the 22 to 24 range.

Stephen Kim

Analyst, Evercore ISI

Q

Okay. That's helpful. Appreciate it. Next question is related to inventory. I was curious if you could give us a sense maybe, Marty, what your expectations are for inventory dollars either for the average of full year 2024 or by year-end 2024, maybe you could put it in terms of inventory turns, if you like, or in just the dollar change. And at year-end – at the end of fourth quarter, what was your sticks and bricks number?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

I'll let the team scramble to find that sticks and bricks number. In terms of inventory turns, it's a focus of ours. Our spec strategy should improve that. Our mix shift to more affordable luxury and more active adult which are easier to help with that turns, their quicker to build should be important for us. We do have a number of specs that are already in our inventory balance right now, so I don't think you're going to see our inventory balance grow dramatically this year compared to where it is right now, Stephen. And right now, what have we got for construction in progress, Gregg?

Gregg L. Ziegler

Treasurer & Senior Vice President, Toll Brothers, Inc.

A

CIP is \$5.5 billion.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

\$5.5 billion is our construction in progress. That includes the backlog and it includes – around 40% of that is land and improvements.

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

Mike Dahl

Analyst, RBC Capital Markets LLC

Q

Hi. Thanks for taking my questions. Just a follow up on that, Marty. I think it's interesting, the inventory dynamic, because as you're kind of shifting towards spec and projecting this increase in deliveries, your backlog is still down and your construction in progress is actually down both sequentially and year-on-year. Maybe some of that is the mix shift to lower priced homes, but it does seem to imply your expectations for a pretty significant increase in inventory turns or improvement in cycle times. So can you just elaborate a little bit on that more and give us a sense maybe of where you're at in terms of current homes under production in unit terms for specs and how you expect to stage that through the spring?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Sure. So in addition to the 6,600 or so homes that are in backlog, we have roughly another 2,700, 2,800 homes in various stages of construction that we define as quick move-in or spec homes. Around 400 to 500 of those are at [ph] CO (00:32:42) or beyond, and I think we're very comfortable at that level.

As it relates to the inventory balance, our backlog came down rather significantly from the end of last year to the beginning of this year, and it's been replaced, if you will, in the inventory with these spec homes that I just mentioned.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And then Marty, just to help clarify that also, what we call the finished specs, which are those that a client can move-in in the next couple of months, it's only 1.5 homes per community that are specs that are at or very close to [ph] CO (00:33:28) and we can offer up to the client as that great alternative to a resale home that is not on the market at the moment.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

And remember, we define a spec as a home that has a foundation poured. Not all specs are full-go to completion. Many of them are sold in the construction process at various stages of completion, and we very actively manage the stages of go-no-go in advancing the construction on those homes.

Operator: Thank you. And our next question today comes from Michael Rehaut with JPMorgan. Please go ahead.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

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

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Thanks, Mike.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Thanks, Mike.

A

Michael Rehaut

Analyst, JPMorgan Securities LLC

First question, I just wanted to circle back to some of the commentary around the more recent trends and the outlook for first quarter orders being a little better than historical seasonality. And importantly, you kind of highlighted that you didn't really have to raise incentives in October, and I believe you raised pricing during the quarter, the past quarter about 1%, 1.5%.

Q

Given where we are today and maybe some of the more recent trends that we've seen going into the current quarter, and some of the optimism, I guess, that you talked about around the recent decline in rates into the spring, how should we think about like-for-like pricing in 2024, particularly as you're still seeing pockets of inflation here or there across the construction cost spectrum?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Great question, Mike. We certainly don't have a crystal ball as to where the spring will end up, but I will tell you that I am a lot more encouraged sitting here in the middle of December than I was a year ago. On October the 19th, we hit 8.25% for a 30-year no-point mortgage. And I checked the rate sheet this morning before I walked in here. And today, we're at 7.25%. So we're down 100 basis points in the 30-year mortgage in six weeks.

A

It's December. I can't sit here and tell you that that's translating immediately in the last couple of weeks' results because of seasonality, but it sure feels good heading into the spring season. And, boy, the timing couldn't be better for rate to drop like that in December, setting up that mid-January launch of the spring season when most homes are sold.

The 10-year's at 4.17%. Remember, the historic spread from the 10-year to the 30-year is 170 basis points. If that historic spread was in play today, that's a 5.875% mortgage off of this 10-year. I think we all believe the 10-year still has room to move south. And at some point, when there's more confidence in the longer-term macroeconomic outlook, the spread's going to come down from where it is now to something closer to that 170 basis points.

So, again, I don't have the crystal ball on rates, but it sure feels good and there's reason to believe that this 7.25% we sit at today may even get better, and that just sets up really well for this spring season. Where we have the most pricing power? That will be market by market. We make those decisions on a very local, community-by-community basis. We have many, many communities opening during the spring season.

We talk about 10% community count growth, but that's a net number. We're going to have many communities sell out, and we're going to have over 100, two a week new communities opening in 2024. And over the last few years, there's been a lot of hype with the launches of these new communities because of the pent-up demand as people wait for that new community to open up.

So I know it's a soft answer for you, but that's the best I can give you. But sitting here today, with where rates stand, with where sentiment stands, with how the company is positioned, with new openings and with the spec strategy that we'll be adding more homes available to purchase at various stages of completion as we roll through

this coming spring, we have optimism. And therefore, we think we will be able to raise prices, and we will be able to continue to manage, and hopefully continue to modestly decline the incentive – reduce the incentive.

Michael Rehaut

Analyst, JPMorgan Securities LLC

Q

Right. No, no, no, that all makes sense, Doug, and I appreciate the answer. Maybe secondly, just kind of looking at some of the broad strokes around order trends and you talked about sales pace maybe being potentially around [ph] 26 (00:39:14) versus maybe that's up about 10% or so versus the last year or two. Talking about community count, also up about 10%, so you're talking about roughly a 20% growth in orders if those numbers kind of flow through. That would still kind of trail the midpoint of your closings for the year. And so, you'd actually end up with a backlog down year-over-year once again in 2024.

As a result, in order to have closings growth in 2025, you'd actually have to further turn your beginning year backlog faster, maybe something 1.8 times or something around that if you're having a moderate level of closings growth. Is that something you're comfortable with in that type of scenario? Obviously, you talk about spec increasing as a percent of sales. I don't know if that would continue to increase in – over the next year or two. You have turned your beginning backlog in that 1.5 to 2 times range in the past. So, is that a scenario that that is reasonable in your view?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yes. We are committed to the new spec strategy. I think in the industry, we're on the low end, for sure, with the percentage of our homes at our spec. We're very careful in that strategy. But as we've strategically come down in price point, there are more opportunities for us to build more spec. We also know there's a void with the tight resale market.

For those buyers that want to move in faster because maybe they went to market and were looking for a resale, they couldn't find what they wanted, but they had in their mind an earlier move-in date than the typical 12-month build-to-order construction cycle time. And so, yes, the strategy is working. We are committed to it. And as Marty said earlier, many builders define spec as a home that's much further along and there's no opportunity for choice.

We put many of our specs on the market when they're being framed, and on occasion, more than on occasion, regularly, we may slow down construction as drywall is being hung so that the buyer has that opportunity to pick their flooring, pick their kitchen cabinets, pick their countertops, pick their cooler, plumbing fixtures, et cetera, et cetera and that still offers the buyer the opportunity to go through the design studio process, [ph] have a home (00:42:09) that they feel is custom to their lifestyle, but it's still a much quicker delivery than if they started fresh before we'd even pulled a building permit. So this strategy is now in its second full year. It is working, and it will continue to drive growth in the future.

Operator: Thank you. And our next question today comes from Alan Ratner with Zelman & Associates. Please go ahead.

Alan Ratner

Analyst, Zelman & Associates

Q

Hey, guys. Good morning. Congrats on the great year.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thanks, Alan.

A

Alan Ratner

Analyst, Zelman & Associates

Doug, a couple questions. I know you're still somewhat early on in the spec shift, but I'm curious if you can give a little bit of color in terms of how specs kind of just performed in comparison to build-to-order, obviously margin is probably the main focal point, but do you see any differences in kind of how spec buyers behave when rates are volatile in either direction, either up or down, or any other kind of interesting observations you've kind of taken as you've grown that part of your business?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Sure. So let me first start on the numbers. Our specs sell for about \$200,000 less than build-to-order. And that's because of two things. We generally don't build a spec on the high lot premium lots. We save the best lots for those clients who want to go build-to-order, because we know the build-to-order crowd, when they get into our design studio, they spend a lot more money. And so part of that \$200,000 lower price is a more average lot premium and it's less upgrades.

A

We make sure the specs are fully curated with great finishes, we bring in nationally-acclaimed designers that do the interior design of our model homes, to come up with great packages, but we don't go wild and we don't overdo it. And so naturally, that price is a couple hundred thousand dollars lower. We also tend to build more specs in less expensive communities because you have more buyers. The lower you go on price, the bigger the market you have. Generally, specs gross margin is about 250 basis points lower than build-to-order.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right now.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

At this moment in time.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

Right.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Now, we are encouraged that that spread is tightening a bit. But as part of our new business model, we've accepted that. We're not disappointed by that at all. We're happy with that because when you blend the build-to-order model and, by the way, another stat that's related to this, we are now at 26.5%, reflecting lot premium plus upgrades for the build-to-order client. That used to be 21%.

A

So those that are going build-to-order, they're taking the best lots with the higher premiums, and they're spending more money on both structural and finish upgrades. And therefore, because as we talked about, our gross margin coming out of our design studios is up at 40%. The build-to-order business model is driving terrific margins. We are happy to weigh into that, to blend into that a spec margin that's 2.5 points lower, because the overall package, as you can see, is pretty darn good and we're driving a nice high margin. So that, I hope that helped you, Alan, with the breakdown of the price point of the spec and the margin of the spec.

Alan Ratner

Analyst, Zelman & Associates

Q

Yeah. That's all really helpful. Definitely gives us good insight into how that mix will unfold. So appreciate all the detail there.

Second question I had is on the land side. I know there's been a few questions on inventory turns and things like that. You guys are making great progress towards the 60% option goal. I'm curious if you have a goal or a target or maybe you're content where it is today in terms of where your supply of owned lots can go. Obviously, as you option more land, that has some impact. But your supply of owned lots has been pretty steady in the four-year range, plus or minus, over the last several years, even as the option share has moved higher.

And I would think that that would be one lever you could pull to further improve those turns. So, is there a target in mind? How low could that number go with your business model? Obviously, all your peers are closer to two years, but you have a bit of a different model there. So any color you can give there would be great.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure, Alan. I think a long term goal for us is to get down to 2 to 2.5 years of owned land, with almost a year's worth of that owned land having a backlog home or a spec home on it in various stages of construction.

Operator: Thank you. And our next question today comes from Rafe Jadrosich with Bank of America. Please go ahead.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Hi. Good morning. It's Rafe. Thanks for taking my questions. Just following up on the last question on the difference between spec and BTO, can you talk a little bit about the return on inventory on spec or return on equity on spec versus the built-to-order?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. The spec homes on average take about two months less to build and deliver.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Got it.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

So, Rafe, the return on equity from the spec homes is a little higher than the return on equity for the built-to-order homes, and the inverse relationship of the gross margin is the balance we're trying to play there.

Rafe Jadrosich

Analyst, BofA Securities, Inc.

Q

Got it. That makes sense. It's very helpful. And then just on the order commentary for the first quarter, sort of what you're seeing quarter-to-date, the comment that it's sort of generally in line with normal seasonality or maybe a little bit better. You do have more communities right now. And then mortgage rates, as you said, have come down. Why wouldn't it be better than normal seasonality? Is that just because October didn't actually really slow that much or is it just a slow period in December, is it a community timing? How come it's not better than normal seasonality just given you have some incremental tailwinds quarter-to-date?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Well, it's seasonality. The November and December historically are slower months. You've got – obviously, we know the holidays you have from Thanksgiving through New Year's. And I'm actually pleased that we're trending where we are. We've already said that historically Q1 is down 20% because in Q1 you have this November and December, but we're hopeful. And it's a combination of the sales we've had to date to start the first quarter, plus these pretty dramatic drop in rates over the last few weeks, setting up what we think, not from now through New Year's, but in early January, we have, I think, very solid, legitimate reasons to believe that the market's going to – we're going to have a good start to that spring season in January. We're going to do better than that historic 20% down.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Rafe, when we talk about seasonal trends, we're talking about on a per community basis as well. So, we've kind of already adjusted for a little bit more communities.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right. And one week doesn't make a trend, but last week was a really good week. And I'm not going to read too much into that, but we're going to stay where we are, which is it feels seasonal, the norm is down 20%. We think we'll do a little better.

Operator: Thank you. And our next question today comes from Alex Barrón with Housing Research Center. Please go ahead.

Alex Barrón

Analyst, Housing Research Center LLC

Q

Yeah. Thanks, guys, and great job. I wanted to ask in terms of incentives, particularly rate incentives, what seems to be working for you guys better or what are you offering that clients are [indiscernible] (00:51:49)?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Alex, it's a great question. It's very interesting for us and this may be a bit different from the other builders. We have all the programs the other builders have. We've got the 2/1 buydown. We've got the 3/2/1 buydown. We'll

take your 30-year rate from now 7.25% to 5.625%. [indiscernible] (00:52:13) we'll call our mortgage company, we'll figure it out and it's a great front end marketing tool. It's all over our website. It's all over the email, marketing campaigns we have with our clients. It drives traffic into our communities.

Very few take it, and the reason is, if we're buying your rate down, we're looking at a 30-year timeframe and most clients think to themselves, you know, I'm going to be in this house five to seven years, which is the average amount of time that you're in a home, or they think, I think I can refi at some point before that five to seven years and the incentive that Toll Brothers is wrapping into this rate buydown, they have offered me as an alternative incentive to go have fun in the design studio and have a discount or a credit in that design studio, and I'd rather upgrade my house on them than take advantage of a rate buydown.

So it's driving traffic. It's conversation. But we are not seeing the stickiness that maybe others are. Part of it is 26% of our buyers are all cash, and those that get a mortgage have a 69% LTV. And I think maybe – they're obviously more affluent. Maybe they take a little lower mortgage than they would otherwise have. That's particularly true in active adult, where that LTV is probably closer to 50% because they have more equity coming out of their existing home and they're thinking to themselves, I'd rather use the money to upgrade my home and refi earlier than maybe the formula shows. And so we market a heck out of it, but we don't see a lot of takers.

Alex Barrón

Analyst, Housing Research Center LLC

Q

Okay. Well, I appreciate that answer. It's very great. Many other builders have been using forward commitments to push close to completion specs. Are you guys doing any of that?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yes. Yes. And further along the home is, the less expensive the buydown is because you can lock a lower rate for 60 days for less cost than locking that rate for 90 or 120 days. So, yes.

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Buydown's got cheaper over the last month as well.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Buydown's definitely got cheaper. You're buying down from 7.25% instead of [ph] 8.125% (00:55:15). So that – thank you, Marty. That's exactly right. The other nice piece of news here that I'll throw in, the loan limit on a conforming Fannie, Freddie is up \$313,000 since 2018. It just went up again and that helps the business.

Operator: Thank you. And our next question today comes from John Lovallo with UBS. Please go ahead.

John Lovallo

Analyst, UBS Securities LLC

Q

Hey, guys. Thank you for squeezing me in here. Just a couple of quick ones. The first one just following up on Rafe's question, the comment that you guys made about a little bit better than normal seasonality. Was that specific to absorption or was that for the total orders in the first quarter or order growth?

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Absorption.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

As measured by deposits.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

As measured right now by deposits.

A

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

For our community.

A

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Because whenever we give you guys some flavor on what's happened since the end of the quarter to the call, and it's usually three or four weeks, but because it's fiscal year end, it's five weeks, that information is always based on deposit activity, because as you know, we take a deposit that can then take two, three, sometimes, we hope not, but sometimes four weeks, to convert from deposit to agreement.

A

On that subject, another good stat, historically, we run about 68% of our deposits convert to agreement. In the fourth quarter, 79% of the deposits converted to agreement. So, when the people go through the process, they pick their lot, they give us the deposit, they start the process of finalizing their lot choice, their home design, their upgrades. It's sticky. It's now up to 79% of those deposits move forward.

John Lovallo

Analyst, UBS Securities LLC

Okay. That's really helpful. And then quick follow up here, in your outlook, how are you guys sort of thinking about mortgage rates? I mean, I guess the question is if rates were to stay at a similar level than they were today, how much risk is there to what you guys are talking about today?

Q

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Little. We sold a lot of houses at 8%. We'll sell more houses at 7.25%. And if my long monologue about where the 10-year is and where the 170 basis points spread typically is, and where we think things are coming, if I'm right and we can break through that 7% into 6% land, yeah, every time there's a drop in rates, our business should get better, that's proven true over the past couple of years. So, we are optimistic.

A

Operator: Thank you. And our final question today comes from Truman Patterson with Wolfe. Please go ahead.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Hey. Good morning, guys, and thanks for squeezing me in. First, just want to make sure for clarity, when you were talking about 2024 inventory dollars overall kind of being flattish is the expectations, that included homes under construction and land as well, correct?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Yes. I mean the lands band is a little tough to really project this early compared to the end of the year, but yes.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Yeah, yeah, understood. Just two quick ones for me. You all rely pretty heavily on realtors, given your consumer base. I'm hoping you can remind us what portion of your sales have a realtor associated with them? What's your kind of typical broker commission? And just any thoughts on the preliminary NAR ruling and the impact on your business?

Martin P. Connor

Chief Financial Officer, Toll Brothers, Inc.

A

Sure. So, two-thirds of our sales involve an outside realtor representing our client. On average, we pay that realtor 2.25% of the delivered price of the home. When you do the math, that comes out to 1.5% of total revenue of the company is with third party realtors. It's too early to comment on the NAR litigation. Obviously, there's appeals and there's other litigation that has popped up since that case, but I think longer term, the industry, we are all encouraged to believe that the third party commissions will be coming down.

Truman Patterson

Analyst, Wolfe Research LLC

Q

Okay. Perfect. And then, Doug, you mentioned eventually getting to 60% optioned land. I'm just trying to understand, do you think that could potentially take a pause in 2024 on that progression? We've just been hearing that developer cost of capital and availability is tightening, so it might make it a little more expensive to option those deals, perhaps find better raw land owned deals that you could possibly bring on your balance sheet. Just trying to understand how you're thinking about opportunities in 2024 there.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah. I think it's a fair comment, Truman. Land banking got more expensive. And so we probably did a little bit less land banking, which is one of the reasons that we didn't option as much land. However, even though we're at 50% owned, 50% optioned, and the progression to 60/40 may take a bit more time, that doesn't change our obsession with capital efficiency, with driving IRRs and therefore ROEs, because if we're not going to land bank it, which may keep it off our books and keep it optioned longer, we're going to get terms from our land sellers who purchase money mortgages, where even though we own the land, we don't pay for it until some date in the future through a purchase money mortgage format. So the IRRs are still being driven and are still very much focused on as we underwrite land, even if it's taking a bit longer to move the option bucket higher.

Operator: Thank you. This concludes our question-and-answer session. I'd like to turn the conference back over to management for any closing remarks.

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Rocco. You've been terrific. Thank you everyone for your interest and support of our great company, and we wish all of you a wonderful holiday season.

Operator: Thank you. The conference is now concluded, and we thank you all for attending today's presentation. You may now disconnect your lines and have a wonderful day.

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