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Toll Brothers, Inc. (TOL)

Q4 2024 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and welcome to the Toll Brothers Fourth Quarter Fiscal Year 2024 Conference Call. All participants will be in listen-only mode. [Operator Instructions] After today's presentation, there will be an opportunity to ask questions. [Operator Instructions] The company is planning to end the call at 9:30 when the market opens. During the Q&A, please limit yourself to one question and one follow-up. Please note this event is being recorded.

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

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

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

As usual, 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. Please read our statement on forward-looking information in our earnings release of last night and on our website to better understand the risks associated with our forward-looking statements.

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I'm incredibly proud of our company's performance in fiscal 2024. We ended the year on a high note with a very strong fourth quarter. In the quarter, we delivered 3,431 homes and generated $3.3 billion of home sales revenues, up 25% in units and 10% in dollars compared to the fourth quarter of 2023.

Our adjusted gross margin of 27.9%, beating our guidance by 40 basis points, and our SG&A was 8.3% of home sales revenues, or 30 basis points better than guidance. Both top line and margin outperformance contributed to earnings of $475 million, or $4.63 per diluted share, up 7% and 13%, respectively, compared to last year's fourth quarter. In addition, contracts were up over 30% in both dollars and units in the quarter.

For the full year, we generated a record $10.6 billion of home sales revenue, over $2 billion of pre-tax income, and over $1.5 billion of net income, resulting in record earnings of $15.01 per diluted share, and a return on beginning equity of 23.1%, the third year in a row we've generated returns above 20%. We delivered 10,813 homes at an average price of approximately $977,000, and with an adjusted gross margin of 28.4%. Our SG&A expense was 9.3% of home sales revenues, and our operating margin was 18.8%.

In addition, we grew contracts by 27% in both units and dollars, and increased community count by 10% to 408 communities at year-end. These are exceptional full year and quarterly results, demonstrating the power of our luxury brand, and the financial strength of our more affluent buyers. Our strategies of increasing our spec production, widening our geographies, price points and product lines, and focusing on operational and capital efficiency are working.

As I mentioned, we finished the year strong with fourth quarter contracts up over 30% in both dollars and units. We achieved this in the face of election uncertainty and mortgage rates that increased by nearly 100 basis points from mid-September to mid-November. Since the start of the first quarter of our fiscal 2025 six weeks ago, we have seen strong demand. With the uncertainty of the election behind us and mortgage rates trending in the right direction, we are encouraged by our traffic, deposits and agreements, and are optimistic for the start of the spring selling season in mid-January.

Our positive outlook reflects the long-term fundamentals that continue to support the market for new homes generally, and Toll Brothers in particular. These include favorable demographics driven by millennials, many of whom are buying their first home later in life when they have higher incomes and accumulated wealth, and baby boomers who are moving in retirement.

Due primarily to the well-known affordability issues in this country, the average age and wealth of a homebuyer has increased. According to data published by the National Association of Realtors last month, the median age of a first-time homebuyer is at an all-time high of 38 years old, and the median age of all buyers in the market is now 56 years old.

In addition, first-time buyers comprised just 24% of the market over the past year, the lowest level in over 40 years. This means the vast majority of buyers in the market are move-up or move-down. These trends play right into our wheelhouse. Approximately 28% of our business is selling to older, more affluent first-time buyers, and the balance is catering to move-up and move-down buyers who are financially secure and have significant equity in their existing homes.

In fact, according to the Federal Reserve data, 73% of the value of existing homes today is equity. In addition, the resale market, our primary competition, continues to be locked up by persistently high rates with over half of outstanding mortgages under 4%. With limited inventory driving resale prices higher, the new home premium,

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which averaged just 3% this year, is the lowest premium it has been in decades. New homes are available and a great deal compared to resales.

The median age of an existing home in the US is now over 40 years old, with well over half of them built before 1980, making new homes very attractive. They are built better, require less maintenance, are less expensive to insure, are more energy efficient, and most importantly, are designed architecturally to appeal to today's buyer.

Many are also part of communities that have sought-after amenities. It is simply impossible or prohibitively expensive to remodel most existing homes with today's new home features, making the value proposition for buying new even more compelling.

While we recognize that affordability is a broad market issue, our more affluent buyer is less impacted by it. In our fourth quarter, approximately 28% of our buyers paid all cash. Consistent with the trend over recent quarters and significantly above our long-term average of approximately 20%. The loan to value ratio for our buyers who took a mortgage in the fourth quarter remained at approximately 69%. So, for the 72% of our buyers who took a mortgage, on average, they put down 31%.

Our cancellation rate as a percentage of backlog remained low at 2.5% in the fourth quarter. Our industry-low cancellation rate is due to the significant upfront down payments our buyers make, as well as the emotional attachment they form as they personalize their homes with us at our Design Studios.

In the fourth quarter, structural options, Design Studio finishes, and lot premiums averaged $203,000, or 25% of the average base sales price. For the year, our Design Studios generated over $1 billion in sales, and provided a great source of accretive, high-margin revenue for us. Each of these metrics, our high proportion of all cash buyers, low LTV ratios, low cancellation rates, and a substantial amount that our buyers spend on lot premiums and upgrades at our Design Studios highlight the financial strength of our customer base. I'd also point out that we are benefiting from the greatest generational wealth transfer in history as many parents are looking to help their kids with down payments.

Turning back to our fourth quarter. Despite the sharp increase in rates in the second half of the quarter, we maintained a steady cadence of orders from month-to-month. Approximately 30% of sales occurred in August, with 35% of sales in each of September and October. On a per community basis, we sold at a pace of 2.2 homes per month, up meaningfully from the 1.9 pace we sold in last year's fourth quarter. With our business now split roughly 50/50 between build-to-order and spec homes, we are more focused than ever on ROE, turning inventory and appropriately balancing pace and price. As a result, when the market softened a bit in September and October in response to the spike in mortgage rates and the uncertainty leading up to the election, we modestly lowered net price through incentive increases by an average of $12,000. As a result, our incentives in the fourth quarter were approximately 6.7% of the average sales price, slightly above our recent averages of between 5% and 6%.

This small increase was primarily on finished spec homes, many of which are expected to be delivered in our first quarter. With the market improving, we have recently begun to decrease incentives, and we are optimistic that we will be able to further reduce incentives and also increase base prices with the start of the spring season in January.

We are very comfortable with our inventory of spec homes per community and the gross margin spread between our spec and build-to-order homes. Our spec strategy has allowed us to grow EPS faster, increase our ROE, and

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increase our operating margin by leveraging overhead. We believe this is the right strategy to continue driving attractive returns well into the future.

Turning to land. At fiscal year-end, we owned or controlled approximately 74,700 lots, 55% of which were optioned. Excluding the 5,996 lots committed to homebuyers in our backlog, our optioned land represented 60% of lots. We continue to target an overall mix, including backlog, of 60% optioned and 40% owned over the longer term. We are pleased to have made solid progress towards this goal in this quarter.

We are 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, using 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 three years.

In the fourth quarter, we purchased $201 million of our common stock, bringing our full year repurchases to $628 million at an average price of $127.79 per share.

During fiscal 2024, we repurchased nearly 5% of our shares outstanding at the beginning of the year. We have now bought back half the company since 2016. We also paid $93 million in dividends. Buybacks and dividends will remain an important part of our capital allocation priorities well into the future.

For fiscal 2025, we have budgeted another $500 million of share repurchases, which we expect will be weighted to the back end of the year, consistent with our greater cash flow generation.

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 2024's fourth quarter, we delivered 3,431 homes, and generated home sales revenues of $3.26 billion, up 24.5% in homes and 10.4% in dollars from one year ago. The average price of homes delivered was down 11.3% to approximately $950,000. These results are consistent with our multiyear strategy of widening our geographies and price points, expanding our product lines and increasing our supply of spec homes.

Fourth quarter net income was $475.4 million, or $4.63 per diluted share, compared to $445.5 million and $4.11 per diluted share one year ago. For the full year, we delivered 10,813 homes, the most in our history, and generated record home sales revenues of $10.6 billion.

Full year net income was $1.57 billion and $15.01 per diluted share. As a reminder, net income includes approximately $124 million, or $1.19 per share of gains related to a parcel of land that we sold in the second quarter. Excluding this gain, net income would have been $1.45 billion, or $13.82. We signed 2,658 net contracts in the fourth quarter for $2.7 billion, up approximately 30% in units and 32% in dollars. The average price of contracts signed in the quarter was approximately $1 million, which was roughly flat to last year's fourth quarter.

At year-end, our backlog stood at $6.5 billion and nearly 6,000 homes. As Doug mentioned, our cancellation rate as a percentage of backlog was just 2.5% in the fourth quarter, consistent with our long-term average of 2.3%.

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Our fourth quarter adjusted gross margin at 27.9% was 40 basis points better than guidance, which was due primarily to mix and cost control. We also benefited from reduced cycle times and greater stability in our building costs, which have been impacted by the high inflation of recent years. This past year, we were generally able to keep these building costs flat.

SG&A as a percentage of home sales revenues was 8.3% in the quarter, which was essentially flat compared to 8.2% in the same quarter one year ago. And this was 30 basis points better than we had projected. The outperformance relative to guidance was primarily due to greater fixed cost leverage from higher than projected revenue.

As we continue to focus on ways to become more efficient, we are seeing the benefits flow through our results. In fact, our G&A dollar spend grew only 1.7% year-over-year, despite inflation, 10% community count growth and double-digit percentage growth in both deliveries and contracts.

Joint venture, land sales and other income was $44 million in the fourth quarter, compared to $36 million in the fourth quarter of fiscal year 2023, and our guidance of $47 million. Joint venture, land sales and other income in Q4 2024 primarily related to land sale gains, as well as contributions from our title and mortgage business, and included $6.6 million of write-offs related to Apartment Living joint ventures, and another $2.2 million associated with abandoned projects.

Write-offs included in home sales cost of revenues totaled $24.1 million in the quarter, compared to $8.3 million in the prior year period. There were no land sale write-offs in the fourth quarter of 2024 versus $12.9 million in Q4 2023.

We continued to generate strong cash flow in fiscal 2024, with approximately $1 billion of cash flow from operations. We expect to generate a similar amount this year. We ended the fiscal year with over $3.1 billion of liquidity, including $1.3 billion of cash and $1.8 billion available under our revolving bank credit facility.

In fiscal year 2024, we invested $2.8 billion in land acquisition and development. We also returned $716 million to shareholders through share repos and dividends. Our net debt to capital ratio was approximately 15% at fiscal year-end, and we have no significant debt maturities until early fiscal 2026. Our balance sheet is in great shape.

Turning to our guidance. We are projecting first quarter deliveries of 1,900 to 2,100 homes with an average price between $925,000 and $945,000. 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 year 2025, we are projecting new home deliveries of between 11,200 and 11,600 homes, with an average price between $945,000 and $965,000.

We expect our adjusted gross margin in the first quarter of fiscal 2025 to be 26.25% of home sales revenues, and for the full year to be approximately 27.25%. Our projected gross margin for Q1 primarily reflects the impact of mix, and the increased incentives offered in our fourth quarter to move finished spec inventory and to counter softness in the market, resulting from election uncertainty and the spike in mortgage rates. We view our Q1 adjusted gross margin as a bit of an anomaly from both a mix and incentives perspectives, and fully expect it will be the low point of the year.

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I wouldn't read too much into it. We are very comfortable with our full year guide of 27.25%, implying approximately 27.5% for the balance of the year. We expect interest and cost of sales to be approximately 1.2% of home sales revenues in the first quarter and for the full year.

We project first quarter SG&A as a percentage of home sales revenues to be approximately 12.7%, reflecting lower fixed cost leverage, as the first quarter tends to be our lowest revenue quarter. Also included first quarter SG&A is about $15 million of our annual accelerated stock compensation expense that does not recur in the remainder of the year. For the full year, we project SG&A as a percentage of home sales revenues to be generally consistent with 2024 and in the range of 9.4% to 9.5%.

Other income from unconsolidated entities and land sales gross profit is expected to be $33 million in the first quarter and $110 million for the full year, and includes the projected sale of several stabilized apartment communities.

We project a first quarter and full year tax rate of approximately 22% and 25.5%, respectively. We expect our first quarter tax rate to benefit from higher deductions related to previously granted equity awards that we do not project to recur for the balance of the year.

Our weighted average share count is expected to be approximately [ph] 102 million (00:23:30) for the first quarter and 100.5 million for the full year. This assumes we repurchased a targeted $500 million in common stock for the year, with most of that occurring later in the year, aligned with our anticipated higher cash flows.

Based on land we currently own or control, we expect to grow community account by 8% to 10% by the end of fiscal 2025, and are targeting 440 to 450 communities.

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

Douglas C. Yearley, Jr.

Chairman & Chief Executive Officer, Toll Brothers, Inc.

Thank you, Marty. Before we open it up to questions, I'd like to thank the entire Toll Brothers team for staying focused on our customers, and consistently executing on our core strategies. Most importantly, you've helped position the company for continued success in 2025 and beyond. For that, I am truly grateful.

Drew, let's open it up for questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. 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] The first question comes from Stephen Kim with Evercore ISI. Please go ahead.

Stephen S. Kim
Analyst, Evercore ISI
Q

Yeah, thanks very much, guys. Appreciate all the color. Certainly, I think the results in the quarter were strong on the order front. Your ASP was also very strong. You've talked about the guidance for the first quarter, though, and for the full year that are a little lower than, I think, we and many others were expecting for the full year, as well as the quarter.

I wanted to talk about the operating margin. If we just kind of cut through the gross and the [ph] SG&A (00:25:37) and just talk about the operating margin, it seems like you're guiding to something in the neighborhood of like sub-17. You've done 18% in each of the last two years, basically. I'm curious if you can talk about what sort of exogenous factors or factors that are out of your control are you embedding in your assumptions for 2025, in terms of the market outlook. I'm thinking things like – can you give us a sense of what you're looking for for mortgage rates. Can you give us a sense for – if you're anticipating any disruptions from, let's say, Trump's immigration policies and things like that.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Thanks, Stephen. That's a big one. A lot of parts to that question. We're pleased that mortgage rates have begun to stabilize and even come down modestly. We and the industry were obviously disappointed that from mid-September through mid-November rates went up as the Fed was lowering short-term rates. But I think we are hopeful and have some good reason to be hopeful that rates will either stay where they are or more likely moderate a bit. They have been stubbornly high.

We have sold well, as we talked about in the fourth quarter when the rates were elevated. And that really goes to all the stats we gave you about the percentage of cash buyers and the LTV ratios, and the affluent makeup of our buyer group. We don't need lower rates to have success at this company. We just proved it in the last quarter. But we are optimistic that 2025 will be a year where, like I said, rates will either stay where they are or come down somewhat. As I mentioned, we've already begun to cut back on the incentives that were a little bit elevated in the fourth quarter.

And as we traditionally do, as we open the spring season, we tend to have a nationwide price increase, base price increase off the price sheet. And so when you combine that with a reduction in incentives, we – and we think that business plan is in place, we have optimism for next year.

As to your question about disruptions, we are not anticipating disruptions. Obviously, we're keeping a close eye on policy. We are encouraged by a lot of the new policy that we think will be coming our way. And so it's business as usual. We are built to succeed in this type of a market with our geographic mix, our product diversity, our price range, our spec business, and most importantly, the affluent nature of our client.

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Stephen S. Kim
Analyst, Evercore ISI

Q

Got you. Appreciate that color. I didn't catch a cash flow guide for 2025. I was wondering if you could give us that. And is it also – would you – I think I asked you this question maybe a quarter or two ago about what you think the long-term sustainable operating margin range might be. And I think at that time, you had mentioned something in the neighborhood of 17% to 18% or 17.5%. Is that something that you still believe that general range is where you could sustain your operating margin longer term, you think?

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Stephen, we are comfortable with the 17% to 18% range of our operating margin. And as it relates to the cash flow, we did $1 billion approximately in 2024, and we project a similar amount in 2025.

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

John Lovallo
Analyst, UBS Securities LLC

Q

Yeah. Hi. Good morning, guys. Thanks for taking my questions. I'm going to dovetail off of Steve here for a moment. With the cash flow projected to be about the same year-over-year, why is the intent to buy back less stock of $500 million versus the $628 million that you guys did in fiscal year 2024?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

John, it's a guide. In the last year, we started the year at $400 million guide and we actually bought over $600 million. But as we enter the year and we look at the growth of our business, and the land we're buying and the roads we're putting in, and the cash flow we're generating, at this moment in time, we are comfortable at that number. If history repeats itself, we're going to do more, but we're not at this point in time prepared to guide to what we did last year. But as I think we've proven to you, that opportunity may be out there and we would take advantage of it.

John Lovallo
Analyst, UBS Securities LLC

Q

Yes, that makes a lot of sense. And then, on the first quarter gross margin, I think you guys explained that pretty well with mix and higher incentives on finished specs that are going to deliver in the first quarter. But I guess the question is, the 27.5% that we would need through the remainder of the year, is there a cadence that we should think about for that? And does it assume that interest rates actually come down from here or could you achieve it at rates that are at the same level or potentially a tad higher if that's the way things went?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So I'll start. Marty will finish. It does not assume rates come down. It does not assume an improving market. I think we set up for you in our prepared comments the opportunity in an improving market to do better. But it's not our company's style to build that into guidance. And so, that's how we approached the year.

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Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Yeah. And as it relates to the margin cadence, I think 27.5% on average through the last quarter without much deviation from – the last three quarters, without much deviation from that is a good set of assumptions to use.

Operator: The next question comes from Trevor Allinson with Wolfe Research. Please go ahead.

Trevor Allinson
Analyst, Wolfe Research LLC

Q

Hey. Good morning. Thank you for taking my questions. First question, I want to visit some of your positive demand commentary. You mentioned demand over the last six weeks has been pretty strong. Can you provide any additional color around that, now that we're post-election, perhaps on traffic rates or absorption paces and then any differences that you guys are seeing between your different consumer segments.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So traditionally, if you look back in time with Toll Brothers, the first quarter is on average down about 10% from fourth quarter in terms of sales, and we are trending better than that. We are projecting now, halfway through the quarter, about two contracts per community per month. So if you do the math off of that, you'll be able to figure it out.

Actually, the guys are going to do it for me right now. So it's going to – it's in the 2,400 to 2,500 range when you take 2 per community times the 400, plus or minus, communities. So there you have it. And that is better than traditional trends of how Q1 compares to Q4s.

Trevor Allinson
Analyst, Wolfe Research LLC

Q

Okay. Thank you. That's helpful and very encouraging. And then the second question is on your lot supply. You mentioned in your release having all the lots you need to grow in 2026. As we look at your lot supply currently on a four-year supply basis, it seems like it's down a bit from where it's been in the last few years. So the question is, as you stand here today, given your outlook for 2025, demand is still healthy for your product. Do you need to accelerate the lots you have under control from here? Thanks.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

No, I'm very proud of our land buying, very happy with the optioned versus owned momentum that is taking place to be more capital efficient. We have become more creative in how we buy land. Tie it up now, pay for it later. Big deals do joint ventures with other builder friends or with Wall Street money, more and more land banking. Our goal is to have 1.5 to 2 years max owned land and...

Gregg L. Ziegler
Senior Vice President, Investor Relations & Treasurer, Toll Brothers, Inc.

A

Net of backlog.

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Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Net of backlog. Thank you, Gregg. And we're making progress. We're not there yet, but we're going to continue to move in that direction. So, our deal flow is strong. Our underwriting is very conservative. We demand high margin. We demand high returns. We miss deals that get too skinny, and we're okay with that. We have a great finance group that is very creative about how we can structure deals to keep them controlled longer, owned for a shorter period of time. And so the land business is in great shape, and I'm very comfortable. And I'm really proud that we can grow this company with 10% community count the last two years in the market we're in. So we're in great shape.

And one additional advertisement here. Remember, with the geographies we're in, 24 states, 60 markets, with how we have widened the price point from $300,000 to over $5 million, how we have widened our product lines with a third first time and the – or 30% first time and the balance move-up and move-down, we have the widest of everything in the industry and therefore the most opportunity to grow. And by the way, at our price point, that affluent buyer can absorb some of these bumps we've seen with higher rates with a little bit of consumer sentiment being off now and again. And so the business model is in great shape and I'm very excited about where we're headed.

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

Q

[indiscernible] (00:36:07) on for Mike. Just going back to your incentive comments. You guys saw a step-up in incentives this quarter. You're expecting that to moderate down modestly. Could you just help quantify what you're expecting incentives to kind of settle out as we enter the new year. And then, given your expectation of kind of a nationwide price increase and more moderate incentive load, I mean, what what's your confidence that you'll be able to maintain that, the two per month absorption trend that you guys called out into 1Q and then the rest of this year?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

We think we're going to be settling in in the $55,000 range as the spring season approaches...

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

That's 5% to 6% of selling price.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Right. Which is where we've been and we've already clawed back, as I said, a bit of the modest increases we saw in the fall. So, that's where it is.

Q

Okay. And then you just plan to operate at that level for the remainder of the year, correct, at this time?

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Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

Well, I think the market will dictate where incentives are.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Right.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

We'll continue to lower incentives if the market continues to permit us to do that.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

And don't forget, price increases. Nothing makes us happier, or the backlog, when they see the price sheet go up. So it is a combination. As you're bringing incentives down, you usually have the ability to also take the price of the home up. It's a combined impact.

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

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Thanks. Good morning, everyone. Thanks for taking my questions.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Hi, Mike.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Hey, Doug. First on the first quarter – oh, I'm sorry, fourth quarter description about – I'm sorry, first quarter description about the gross margin being the low point due to a combination of mix and incentives. I was wondering to get perhaps a rough breakout of how much of that difference in the first quarter versus the rest of the year is due to mix versus incentives. And more broadly, when you think about your spec strategy, obviously, you kind of highlighted the higher level of incentives that you applied to the finished spec in your – that you had in the fourth quarter. If the market continues to be a little more volatile, if there's a little bit more, let's say, looseness in inventory or whatnot, would that cause you to shift a little bit away from spec, maybe, versus how you've approached the market in the last couple of years?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So, Mike, about 80% of the lower margin of Q1 is mix. We have less coming out of the Pacific region, and we have less coming out of the Mid-Atlantic in Q1. That reverses itself and gets back to a more normal mix for the balance of the year. The other 20% is what we described, which is through September and October, rates jumped, buyers hit the sidelines as the election was approaching. And most particularly with our finished inventory

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homes, which are the ones that we'll be delivering in Q1, we bumped the incentive a bit to move them. And as we've mentioned, we've seen a lot of that already reversed with the election behind us and with rates now stabilizing or even modestly dropping as we get closer and closer to that mid-January launch of the spring season. Marty, why don't you take the rest of that.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

I think – I'd like to take the opportunity to iterate how returns focused we are, and with respect to any change to our spec strategy, I think that's unlikely based on what it's allowed us to do with returns. And so, we'll continue to be mindful of the specs we have, particularly as market softness might occur, which we don't anticipate right now, but I think we want to reiterate our focus on returns and what we've been able to accomplish with return on equity through the combination of elevated gross margins, high gross margins, good operating margin and capital redeployment through dividends and repurchase.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Yeah, I think it's important to, once again, just quickly explain this new strategy that is now fully in place. When we were building 5% of our communities with spec, in today's market, you would be driving a higher margin because the build-to-order business at the luxury, luxury end of the business, which is what built Toll Brothers, had a higher margin. We would be a much smaller company and we wouldn't be able to drive the same ROE because that land is very expensive. It takes much longer to build the houses and it's much harder to turn the money.

So we are very happy with a blend that may be a little bit below that build-to-order margin because we recognize the spec margin, it's at a lower price point. It tends at times to have to be incentivized a little bit more. But when you put it all together, it's still a great margin. We're a much bigger company, more revenue, more EPS, and we are much more capital efficient. And so as we move forward, this mix, we think, is perfect for the business that we are achieving.

Michael Rehaut
Analyst, JPMorgan Securities LLC

Q

Great. Appreciate that bigger perspective as well. I think it's helpful. Secondly, I'd love to just revisit your comments around the strong start to the first quarter, and just trying to understand a little bit better what you think are the drivers behind that. In other words, is it some of the election uncertainty that's maybe gone away? Is it rates perhaps stabilizing? And also, to kind of delve into just the broader market trends, I'd love to get your sense of how inventory is trending, in your view, across your key markets. If there's any markets where you've seen inventory pickup and how that might be playing into market dynamics as well.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. So, why did the market get better in November? Number one, the election was behind us, number one. Those on the sidelines came back out. Number two, a good to great economy. Number three, rates stabilizing, coming down a bit and being digested and accepted by the client. We talked about it earlier. The significant equity that three quarters of our buyers because three quarters of our business is move-up and move-down, significant equity they have in their houses and therefore their ability to trade up and maybe pay all or more cash by using that equity and not being as tied to the affordability issues of the higher rates. Affluent buyers, it's not just those that have equity in their house. They're just affluent buyers with good investments in the market that have done well and good jobs.

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We have a stock market that has been performing very well. Now, some of that you'll say, well, that occurred in October. That's why I started with post-election, because I think all of those other components, while many of them had been in place pre-election, the election being behind us freed it up.

And so – and the wealth transfer, I didn't even mention, which is we've said in our prepared comments, incredible amount of money being passed down from mom and dad to their kids so they can buy their home, usually their first home. So I think that is the driver and we're excited for January.

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

Rafe Jadrosich
Analyst, BofA Securities, Inc.

Q

Hi. Good morning. Thanks for taking my question.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Good morning

Rafe Jadrosich
Analyst, BofA Securities, Inc.

Q

Just following up on the first quarter gross margin guidance and then the improvement in the second and – through the second through fourth quarter. Can you just talk about maybe what you're assuming for spec margins. I know it's a little bit different for you because you have different levels of spec, whether it's sold pre-drywall or it's finished spec. So what are you assuming for spec margins in the first quarter and then for the rest of the year?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

So our spec margin runs about 200 basis points below the average gross margin. So we've been guiding to 27.25% for the year. You can do that math. And our build-to-order margin is about 200 basis points above that average gross margin. In the first quarter, because we incentivized a little bit more, as we talked about, on finished spec that is delivering in the first quarter, that 200-basis-point spread is a little bit more.

Rafe Jadrosich
Analyst, BofA Securities, Inc.

Q

Yeah. And then assuming it goes back to normal for the normal spread in the remainder of the year?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

That is our assumption, that's right.

Rafe Jadrosich
Analyst, BofA Securities, Inc.

Q

Okay. All right. That's helpful. And then I think, Doug, in the past, you've spoken about some either regional or market differences. When you look at the fiscal – the fourth quarter and heading into the fiscal first quarter, where are you seeing relative pockets of strength and then where – are there any specific markets where you've had to

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be a little bit more aggressive on the incentive side? Or are there specific regional trends or is it by price point? Can you just talk about the relative differences?

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Sure. We have broad-based strength around the country, the Boston to Washington, DC market, which was a bit forgotten through the COVID years when everybody was running away, is incredibly strong. Texas, Dallas – there's a lot of chatter about Texas. I would take Dallas and Houston out of that conversation. Right now, we're seeing strength in those markets. Those are by far our biggest two Texas markets and they are back. There is still some softness in Austin that is driven by affordability because Austin prices ran and ran and ran through COVID, and so there's a bit more affordability pressure there with the higher prices.

And in San Antonio, which is a very small market for us, has also been a bit softer. Out west, all good. The only market that we have a little bit of caution out on is Phoenix, where inventories are up a little bit. And while it's good, it is certainly, I wouldn't call it great.

And then the one I am saving for last is Florida. The good news in Florida is Jacksonville has been very strong, but the other markets in Florida have seen some elevated inventory levels. They also had significant price increases through COVID that outpaced the company – excuse me, the country's average, and therefore there's a bit more of an affordability issue down there because prices are up and so we're keeping an eye on Florida. The winter season is just beginning as the snowbirds are arriving, but that's probably our most cautionary market in the country.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.

A

As it relates to product type, luxury is our best performer. Affordable luxury comes in second. And then the third would be our age-restricted active adult, which is really not quite as strong simply because of a very tough comp the year before.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

I think that market is good because there's a lot of boomers and they're paying a lot of cash because of that equity in their house. But on paper, it doesn't look as good right now. But that's really the comp to last year more than the quality of that business today.

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

Alan Ratner
Analyst, Zelman & Associates

Q

Hey, guys. Good morning. Thanks for all the great color so far.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

A

Hey, Alan.

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Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

Hi, Alan.

Alan Ratner
Analyst, Zelman & Associates
Q

Most of my questions have been answered here, but I got a few. First on the potential for tariffs. I'm curious if you guys have done any internal analysis of your supply chain to try to figure out what potential exposure might be there, either from China, Canada, Mexico. And if you've done any work to try to kind of expand your supplier base to kind of avoid some of those risks.

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.
A

Well, we've certainly done some analysis. We've had a lot of good conversations with our suppliers. We went through supply chain issues in a big way through the COVID years. That wasn't tariff driven. It was availability driven. So, this industry and Toll Brothers have some experience on how to navigate through some supply chain challenges. Overall, we are comfortable that it will be de minimis, but we have to wait and see.

I don't think it's clear to anybody yet exactly where and when and to what extent the tariffs hit. I think most of our suppliers are studying it. They're prepared. A lot of them moved, if not to the US, they moved closer to the US in a lot of their manufacturing over the last 5 to 10 years. So this is a wait and see. We're prepared for it. And I don't personally think it's going to be a big issue, but we're not prepared to try to quantify it at this point. We'll just have to see.

Alan Ratner
Analyst, Zelman & Associates
Q

Great. Appreciate the thoughts there, Doug. This one might be for Marty. But, obviously, a huge focus on ROE across the company. And it's pretty visible the steps you're taking there to keep that ROE high. I wanted to just touch quickly on the joint venture line on the balance sheet. You've got about $1 billion invested there. And if I look back historically, the joint venture line on the P&L has traditionally been a pretty solid contributor of earnings. This past year, it wasn't. And I know the composition of your [ph] ventures (00:52:49) have changed. I think historically, it might have been a bit more city living projects, and now maybe it's some land JVs. So, was hoping you could just give a little bit more color on what's embedded in that investment and how we should expect to see that flow through the P&L and the returns going forward.

Martin P. Connor
Chief Financial Officer, Toll Brothers, Inc.
A

Yeah. So, our JV line includes an investment in a couple city living buildings. It's relatively small. It includes investment in our apartment projects that are stabilized or in development. Generally, we absorb a bit of an operating loss during the development period of time and then show a gain on sale. So that's a bit lumpy through the income statement. And then a lot of our JV is what I'm going to call breakeven land development joint ventures with other builders, where it's designed to hold the land off balance sheet, feed the land to each of the builders at cost, and generate higher gross margins on balance sheet on the income statement.

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Operator: The next question comes from Sam Reid with Wells Fargo. Please go ahead. Mr. Reid, your line is open. Is it muted accidentally? Okay. We'll go to the next questioner in that case, which will be Alex Barrón with the Housing Research Center. Please go ahead.

Alex Barrón Q
Analyst, Housing Research Center LLC

Yes. Thank you. Yeah, I wanted to ask about the price cuts you've mentioned. I think I heard $12,000 or something like that. I mean, it doesn't seem like that level of price cut would make a big difference in the affordability of people buying your homes. So I'm just wondering if that's working, what's – is it just more of a emotional thing that gets people over the fence to buy because of that? Is there any offsetting thing you guys are doing, say, on closing costs or something else? Or like, can you just elaborate a little bit on that, how is it moving the needle?

Douglas C. Yearley, Jr. A
Chairman & Chief Executive Officer, Toll Brothers, Inc.

Great question, Alex. Is it working? We had 30% order growth. So yes, it's working in a tough market. Is it emotional? Absolutely. Those stats of 28% all cash and 69% LTV ratio, [ph] that's well grand (00:55:54) isn't necessary to qualify our buyer, but it helps them feel like in what they know is a bit of a softer market because they read about it, they know on the sidelines with an election coming up, they know rates have jumped up. Sometimes it just gives them a little bit that is necessary to make them feel like I squeezed a couple bucks out of total. I got a deal and I'm ready to go. Now, of course, I always challenge my guys. Why did we give it away? Because I bet you still could have gotten them if you didn't give them the extra money. But I usually lose in that argument.

But yes, I think you've nailed it. It's not – we're buying mortgages down so the buyer can qualify for a mortgage at the lower rate because they can't qualify at the market rate. This is much more emotional as we are absorbing sort of the headlines and the softening market. It's how the business rolls. It's very subjective. It's very soft. We reverse it as quickly as we can. We're all about driving price, making that backlog feel great. But during that period of time, we drove orders up 30% by playing around a little bit with the incentive and making our customers feel good.

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

Douglas C. Yearley, Jr.
Chairman & Chief Executive Officer, Toll Brothers, Inc.

Drew, thank you. You were great. Thanks, everyone, for all your support, all your interest. We're always here for you to answer any questions offline you may have. Have a wonderful, wonderful holiday season. And thank you again.

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

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