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TOL - Q4 2017 Toll Brothers Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 revenues of $2.03b and net income of $191.9m or $1.17 per diluted share.

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PRESENTATION

Operator

Good morning, and welcome to the Toll Brothers Fourth Quarter 2017 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded.

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

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Thank you, Chad. Welcome, and thank you for joining us. I'm Doug Yearley, CEO. With me today are Bob Toll, Executive Chairman; Rick Hartman, President, COO; Marty Connor, Chief Financial Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Joe Sicree, Chief Accounting Officer; Kira Sterling, Chief Marketing Officer; Mike Snyder, Chief Planning Officer; Gregg Ziegler, Senior VP and Treasurer; and Don Salmon, President of TBI Mortgage Company.

Before I begin, I ask you to read the statement on forward-looking information in today's release 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 and many other factors beyond our control that could significantly affect future results. Those listening on the web can e-mail questions to rtoll@tollbrothers.com.

We completed fiscal year 2017 on October 31 with both our highest annual revenues and contracts in over 10 years. In our fourth quarter, net income was $191.9 million or $1.17 per share diluted compared to fiscal year 2016's fourth quarter net income of $114.4 million or $0.67 per share diluted. Fiscal year 2017's fourth quarter pretax income was $301.7 million compared to fiscal year 2016's fourth quarter of $168.2 million. Fiscal 2016's fourth quarter was negatively impacted by a $121.2 million warranty charge.

Revenues of $2.03 billion and homebuilding deliveries of 2,424 units rose 9% in both dollars and units compared to fiscal year 2016's fourth quarter totals. The average price of homes delivered was $836,600, basically flat to $834,300 in 2016's fourth quarter.

Demand has remained strong across all of our demographic segments. Fiscal year 2017 was the seventh consecutive year of contract growth. In the fourth quarter, net signed contracts of $1.75 billion and 1,979 units rose 20% in dollars and 15% in units compared to fiscal year 2016's fourth quarter. The average price of net signed contracts was $886,800 compared to $847,800 in last year's fourth quarter.

This fourth quarter was our 13th consecutive quarter of year-over-year growth in total contract dollars and units, highlighted by 20% or higher year-over-year dollar growth in each of the past 5 quarters. We finished fiscal year 2017 with 305 selling communities and intend to grow community count by 5% to 10% by the end of fiscal year 2018. However, I will note that due to the timing of openings and closings, we will end fiscal year 2018's first quarter with about 295 selling communities.

2017's fiscal year-end backlog of $5.06 billion and 5,851 units increased 27% in dollars and 25% in units compared to 2016's fiscal year end. The average price of homes in backlog was $865,100 compared to $850,400 1 year ago. This backlog should result in strong revenue and earnings per share growth in fiscal year 2018.

In 2017, we reaped the rewards of our geographic diversification strategy, particularly in the West. Acquisitions of builders in Seattle in 2011, California in 2014 and Boise in 2017 as well as quality land purchases across all of our Western markets have led to significant growth. California and the West region combined for 47% of our revenue this fourth quarter. California was our largest region. With great land, great homes and great locations, contracts there were up 56% in dollars and 54% in units in our fourth quarter.

We also benefited from our ongoing product diversification strategy. In addition to continued success in our core luxury move-up market, we are expanding our active-adult product line nationally, have introduced a new millennial-focused product line and continue to develop our Toll Brothers City Living and Apartment Living divisions.

Our Apartment Living business continues to expand across the nation. We have well-established divisions focused on urban and suburban markets in the corridor from Metro Washington, D.C. to Boston. In addition, we now have teams focused on growth in Los Angeles, San Francisco, San Diego, Phoenix, Dallas and Atlanta. Our pipeline of completed projects, those in construction, those under development and in the approvals totaled over 14,000 units.

We have begun to harvest some of the value created under our Apartment Living and rental division brand. In fiscal year 2017, we monetized a small portion of the value into recently developed, now stabilized properties through a recapitalization, resulting in income to Toll Brothers of $26.7 million. In fiscal year 2018 and beyond, we expect to continue to grow the income from this business.

Our City Living high-rise division remains active with its primary focus still on the New York City area, including Manhattan, Brooklyn, Hoboken and Jersey City. In fiscal year 2017, we formed separate joint ventures to develop 2 new Manhattan high-rise towers, with projected cost totaling over $600 million. By forming these joint ventures, we will lower our investment, increase our return on equity, reduce our risk and benefit from attractive construction financing. As of today, we have already taken 64 contracts and an additional 12 deposits at these 2 projects: 121 East 22nd Street and 91 Leonard Street.

This quarter, our wholly owned City Living contracts increased in units compared to the same quarter last year, as 10 Provost Street at Provost Square, our first Jersey City high-rise condo community in a decade, continued to sell well. Located a block from the Grove Street PATH Station, this 28-story high rise will contain 242 residences. Since opening this summer, we have taken 93 agreements.

Now let me turn it over to Marty.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Thanks, Doug. Before I address the specifics of this quarter, please note that a reconciliation of the non-GAAP measures referenced during today's discussion to their comparable GAAP measures can be found in the back of today's press release.

Our growth in revenues, contracts, deliveries and earnings per share in fiscal year 2017 reflect the benefit of a strong market, our excellent landholdings, our diverse geographic and demographic product mix and our great brand. I would like to point out that heading into fiscal year 2017's fourth quarter, we had expected to close 3 high dollar condo units in New York City in projects on balance sheet that will instead deliver in Q1 of fiscal year 2018. These 3 units represent $43 million plus in revenues, and their delay was the primary reason for our Q4 fiscal year '17 average delivered price, revenues, SG&A leverage and operating income coming in slightly below our expectations. On their own, these 3 units represent approximately $0.03 of earnings per share.

In addition, the i-joist issues in the North and the West resulted in 35 cancellations and 20 lot swaps, and remediation took a bit longer than anticipated. As of this week, all homes have been remediated, and most of the issue is behind us. We expect all units impacted to be delivered by the end of fiscal year 2018's third quarter.

With our strong backlog as well as significant projected contributions from our joint ventures and other income lines, we expect continued growth in revenues as well as in our earnings per share in fiscal year 2018. We have pursued a number of initiatives to improve our return on equity, including share repurchases, utilizing lower rate variable borrowings, forming capital and risk-efficient joint ventures, optioning more land and increasing absorption. We are up 3 homes per community per year to 25.8 homes for the full year 2017.

We entered fiscal year '17 with a goal of improving our return on beginning stockholders equity to 12% and adjusted that upward midyear to 12.5%. We have ultimately achieved a 12.7% return on beginning equity at the end of fiscal year '17. We expect further improvements in fiscal year 2018.

We purchased 7.7 million shares of stock during fiscal year '17 at an average price of $37.81. We have increased our option lots to 35% of our total lots. 2 years ago, it was only 20%. Based on the midpoint of projected deliveries in fiscal year '18, our year supply of owned land is at 3.8 years with an additional 2.1 years under control.

In fiscal '17, we closed 2 large New York City JVs with total projected cost of approximately $600 million. By using joint ventures and construction financing, we have reduced our projected investment in these projects to $55 million compared to the $600 million if we did them on balance sheet by ourselves.

Conversely, we bought out -- we bought our partners' interest in the Sutton City Living project, and the final units in that project will be delivered on our balance sheet. The combination of these initiatives resulted in significant cash flow.

In our fourth quarter, we retired $288 million of convertible debt, paid off $400 million of senior notes at maturity, repurchased $200 million in shares and spent $383 million to buy and improve land, all while maintaining liquidity in excess of $1.8 billion and lowering our net debt to cap by 390 basis points to 34.5%.

Let me turn to some income statement guidance for fiscal year '18. We expect fiscal year '18 first quarter deliveries of between 1,300 and 1,500 units with an average price of between $820,000 and $840,000 and full fiscal year '18 deliveries of between 7,700 and 8,700 units with an average price of between $810,000 and $860,000.

Adjusted gross margin for fiscal year '18 is expected to come in at 23.75% to 24.25%, a midpoint of 24%. This approximately 75 basis points in contraction from 2017 is associated with 2 primary items. First, our margin in City Living projects delivering in fiscal year '18, while a still very healthy 27.4%, will be below the 35.1% margin delivered in fiscal year '17, reflecting the market conditions we have noted previously in certain New York City buildings and at certain price points. This will impact overall margin by approximately 50 basis points. Second, in California, we expect to see margin decline from 30% in 2017 to a still strong 28.4% in fiscal year '18 as replacement land costs are slightly higher in new communities than those in some communities that are selling or sold out. We expect the balance of our homebuilding business to maintain margin.

For 2018's first quarter, we expect adjusted gross margin of 23.3% based on mix. We expect interest in cost of sales to decline from 3% in 2017 to 2.8% for both the full year and first quarter of fiscal year '18.

SG&A as a percentage of full 2018 revenues is projected to drop 50 basis points to approximately 10% of full year revenues. First quarter SG&A as a percentage of first quarter revenues will be approximately 13.3%, reflective of lower revenues compared to subsequent quarters and some immediate expensing of stock compensation.

While we have mentioned that fiscal year 2017's JV and other income would be outsized compared to prior years, we are pleased to guide to a fiscal year '18 midpoint just $20 million lower than fiscal year '17. The company's full fiscal year 2018 other income and income from unconsolidated entities is now expected to be between $130 million and $170 million with approximately $40 million in our first quarter.

In fiscal year '17, we reported income from sales of portions of our ownership positions in certain apartment projects of $26.7 million. In fiscal year 2018, we expect gains from apartment sales to be more than double that total.

Our fiscal year 2017 fourth quarter tax rate benefited from a $3 million reserve release, resulting from a statute expiration. Our Q4 effective tax rate came in at 36.4%. We estimate our effective tax rate for fiscal year 2018 to be approximately 37% for the full year, assuming no impact from tax reform.

A benefit from the new accounting for excess stock compensation deductions should reduce our Q1 fiscal year '18 tax rate by approximately 3.5% based on the current stock price, thus driving the Q1 rate to an estimated 33.5%. Obviously, the contemplated changes in corporate taxation would be a significant positive to our bottom line if enacted. And since our deferred tax asset has now flipped to be a net liability, any drop in the corporate rate will also create a onetime accounting benefit.

Lastly, our weighted average share count for the fourth quarter was 164.6 million shares. We estimate a weighted average share count for Q1 '18 of 161 million shares. This is down approximately 23.7 million shares, roughly 13% from just 2 years ago, reflecting our share buybacks and the retirement of our convertible securities.

Now let me turn it over to Bob.

Robert I. Toll - *Toll Brothers, Inc. - Co-Founder and Executive Chairman*

Thanks, Marty. We are very pleased with the market as we begin fiscal 2018. There are a number of tailwinds in our favor. Last Monday, the Census Bureau reported the highest new home sales total in a decade. Recently released data from The National Association of Realtors indicates that with continuing solid demand, a small number of months' supply of new home and -- of new and existing homes on the market remains constrained at levels still well below historic norms. This shortage plays to our advantage given our multi-year supply of well-located, geographically diverse and already entitled home sites.

Meanwhile, our customers in the upscale market are benefiting from low unemployment income growth, a strong stock market and attractive mortgage rates. As millennials become a bigger part of the rental market, the rental apartment and new home markets, as growing families seek out larger homes in better locations and as baby boomers buy second homes or move to Active Living communities, we believe we are well positioned for many years to come.

This summer, we celebrated the 50th anniversary of the founding Toll Brothers. From our start as a local builder in the suburbs of Philadelphia, we are now a Fortune 500 company. And we have been named the World's Most Admired Home Builder in the past 3 years in a row by Fortune magazine. Our accomplishments are directly attributable to the diligence and dedication of our Toll Brothers associates to whom we are very grateful.

Thank you. Now let me turn it back to Doug.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Thank you, Bob. Thank you, Marty. Before we take questions, let me very briefly comment on the pending tax reform. On the corporate side, we are encouraged by the potential reduction in the corporate tax rate as it will help our earnings and cash generation. On the personal side, while the potential reduction in the MID, real estate tax and SALT deductions not being helpful to buyers, especially in our coastal regions, we believe they may be offset by a lower stated tax rate, the doubling of the standard deduction, the potential removal of AMT, lower pass-through tax rate and the elimination of the phaseout of itemized deductions. We have always believed that our buyers are generally not tax driven when it comes to buying our home.

The issue of tax reform has been looming for months, and we haven't seen a change in our buyers' behavior. They continue to buy. Sales continue to be strong. With the Senate bill coming out last week, the headlines have only increased, yet this past week had the highest sales for a first week of December since 2005.

So Chad, let's open it up to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question will come from Stephen East of Wells Fargo.

Stephen F. East - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Doug, first, quick follow-up on that tax reform. Do you think this would affect -- with SALT disappearing, do you think this would affect pricing in those markets? And then switching gears to my other question. You all have done a tremendous amount on capital allocation this year, and Marty walked through all of it, which, quite frankly, was pretty impressive just in the fourth quarter alone. So as you look into 2018 and beyond, can you repeat what you were doing there? Where does your focus go? What would you like to do? And maybe put some numbers around that, at least generally.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure, Stephen, I'll take your tax issue, and turn it over to Marty on ROE. It's just too early to tell what exactly will happen with tax reform as the Senate and House bills are now reconciled. If SALT passes where there is limited or no deductibility of state and local taxes, and obviously, California, New York, New Jersey are impacted with higher state tax rates, but I'll reiterate what I said before, we don't think our buyers at our price point are driven by the taxes they pay when it comes to purchasing our homes. We've also studied in some detail a typical buyer in Eastern states and also in California. And again, without knowing exactly where the new bill comes out, when you consider the things I mentioned, which is potentially move all of the AMT, lower pass-through tax rates, elimination of the phaseout of itemized deductions, which is big, because that's the current tax law, and that's proposed not to be the future tax law, it comes across -- it appears as a wash. We're very close to a wash, but our activity in California continues to be strong. We are not hearing from sales managers that buyers are on the sidelines, waiting to see exactly where tax reform plays out before they buy. Remember, California today is not a great state to live in when it comes to taxes, but it's our hottest market because the sun shines, the lifestyle is great and most importantly, there's tremendous job growth. And so I don't think any changes in this tax code as proposed by either the House or the Senate will have an impact on prices in California. Supply houses are still very low. Land is very hard to get entitled. And our buyers out there are very affluent, and our business has been very good over the past couple of months as there's been a lot of headlines about this tax reform.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

And now Stephen, with respect to the capital allocation, as you put it, thank you very much for the commentary. I think the entire management team is pretty proud of what we've accomplished this year. As we look to future years, I think we're going to continue down the various paths we've gone. We have significant financial flexibility to do a number of things, but the first priority has always been to grow the company. And so we will continue to look at land opportunities and company opportunities and apartment opportunities, and we will complement that with the opportunistic stock repurchases, and we are coming up on our 1-year anniversary of our dividend as well. So we will be taking a look at that as another option. Hope that helps.

Stephen F. East - *Wells Fargo Securities, LLC, Research Division - Senior Analyst*

Yes, that does. And then, Doug, last question, going back to orders, you mentioned California. You all have just had huge numbers there. The gross margin, as you look into '18, is coming down a little bit. Could you talk to us some about the decision to run hot around 50%, 60% growth versus the ability to price more? And then along those lines, I didn't catch on the cancellations that's up about 300 basis points. It sounds like a fair amount of that was coming from the joist issue, but if you could put some color around the cancellations moving up.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure. So I'll answer that. That's the easier one. The quicker one. The increase in CAN rate is almost all -- it is all Weyerhaeuser. The flak joist issue, we lost 35 agreements. Weyerhaeuser will fully compensate us for the costs associated with that and having to resell those homes. But that is the reason it spiked a little bit in the fourth quarter. With respect to California, last year, we delivered a whole bunch of homes out of Hidden Canyon, which I know many on the call have seen in Orange County, and that was 50% gross margin, plus or minus. I'm really proud of a 28.5% gross margin coming out of California, and it's mix driven, but what we have right now selling is selling very well. We continue to raise price. Stephen, we will continue to evaluate that trade-off between price and pace. It's, of course, driven by how long the backlogs get and how quickly we can build homes and deliver them, and we evaluate that regularly. But we continue to be set up for great things in California and continue through this call to see terrific demand. I'm so proud of what we're doing out there. Our homes are different. Our communities are different. The buyers and the market recognize it, and I think our future is very bright out there. And like I said, I'll take a 28.5% margin in the California market all day long.

Operator

The next question will come from Alan Ratner of Zelman & Associates.

Alan S. Ratner - *Zelman & Associates LLC - Director*

So I appreciate all the detail on the margin guidance. One thing I thought was interesting, I didn't hear from you Marty, as far as the driver, was the option land piece because you guys have done a great job driving that higher. I think that there's been a lot of chatter in the industry that becoming more asset-light, and you guys getting a 35% option is very impressive. I was curious if how should we think about the margin differential on your option land versus your self-developed portfolio? And if it's not really impacting your '18 margins, at what point should we start to see that reflected? And then just one follow-up to that is how high can that number go? I think there's a lot of discussion about how difficult it is to option land in some of the coastal markets you guys operate in, California, the Northeast. So just curious if you can expand a little bit about what you're seeing in the land market that's allowing you to drive that number higher.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Sure. And I think -- before I address it, Alan, I think we're going to talk about structured options as well as approval options. And structured options is where you find a buyer who's willing to take back some financing or sell it to you over time, and that generally is going to result in a higher cost to acquire the land, and we are seeing a bit more of those opportunities. Although it's always a selective trade-off, buy us as to whether we want to buy the whole thing ourselves and improve margin or maybe defer it over time and improve return on equity. And then you have the approval options where you identify a piece of ground and agree to buy it, subject to you getting approvals. And I think the combination of those are going to work in opposite directions. If you find the land on a nonapproved basis and create the value through approvals, then that would be margin enhancing versus the converse of structured options. So we're looking at both of those types of alternatives as well as the direct initial purchase.

Alan S. Ratner - *Zelman & Associates LLC - Director*

And just in terms of, I guess, the composition then of the options, the 35% today, can you give some split between those 2? And should we expect at some point a kind of a cliff or a gradual impact from more option deals flowing through at lower margins?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think we've given the margin guidance we're going to give for 2018. And with both of these initiatives working in opposite directions, we're going to leave it at that.

Alan S. Ratner - *Zelman & Associates LLC - Director*

Got it. Okay. Second one if I could, Marty, on the tax reform. If we do assume it gets passed and we take your current guidance, probably frees up about $100 million, $100-plus million of additional cash to the company. So I was just curious if there's any big picture views on what you would do with that incremental cash.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Right. I think I'm not sure we get quite as high as you do, but, call it, $100 million, $80 million to $100 million, and it depends on whether that happens in '18 or '19. There's a couple of different alternatives, depending on which body of Congress you're looking at right now. I think we don't have any particular direction for that incremental cash, other than to put it in the general coffers that I spoke about on the first question. And our priority will always be growth of the company through land and company acquisitions, and then we will look at other alternatives as the opportunities present themselves.

Operator

The next question will be from Michael Rehaut with JPMorgan Securities.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

This is Neal BasuMullick, on for Mike. I guess, going back to the gross margin guidance and net of the big pieces you highlighted, I guess, like quarter gross margins are pretty much flat year-over-year. But again, some of the pricing you've been seeing, I want to see if any of the cost buckets have kind of shifted over, maybe labor or raw materials. So any color on that will be really helpful.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure. We continue to feel some pressure on the costs side driven by some material increases but more so labor. It's nothing out of the normal. This past quarter, it's creeping slowly. In some markets, we are offsetting or more than offsetting that cost increase with pricing power, and in other markets, we have been unable to do that. The mix, as Marty stated, when you take out this -- the margin issue coming out of New York City and the very small margin issue coming out of California is that our margin -- our gross margin is flat in our -- the rest of our business around the country, which suggests that we have pricing power that pretty much equals the cost creep. I would highlight that we've had a little more cost increase in Houston because of the hurricane. We have not seen an impact on sales. On the sales side, that market recovered very quickly. But as trades are being pulled towards the repair of houses and infrastructure that was impacted directly by the hurricane, it has made it a bit more expensive, and it's taken a bit longer to build some homes in Houston. It's a very small market for us. It's less than 3% of our business. And the West Coast of Florida, which is also very small, less than 1% of our business, we've had the same issue, although not to the same extent.

Neal Anjan BasuMullick - *JP Morgan Chase & Co, Research Division - Analyst*

Okay. That's helpful. Yes, I guess, on the SG&A side, too, given the really solid improvement you're expecting next year. I guess, what are the really big opportunities you've identified? You talked about some investments in the past. Do you think those will kind of increase the longer-term trajectory of SG&A?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So I think you're referring to our technological investments upgrade in our general ledger package, or our customer relationship management package. Those are still ongoing, and the benefits of those will be beyond the 2019 year, most likely. So we're still in a build and spend mode, not a reap the rewards mode quite yet.

Operator

The next question will be from John Lovallo with Bank of America Merrill Lynch.

John Lovallo - *BofA Merrill Lynch, Research Division - VP*

The first one is on the community count growth expectation of 5% to 10%, which is definitely better than what we were expecting. Are there particular reasons or even community types that are driving this?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure. The community openings for '18, there were -- we project to have 17 new communities opening in Pennsylvania, 11 in Reno, 8 in Seattle, 8 in Northern Cal and 6 in Southern Cal. So those 5 markets lead the list.

John Lovallo - *BofA Merrill Lynch, Research Division - VP*

Okay, that's helpful. And then 2 of your competitors have recently executed what could be potentially transformative transactions, a land developer acquisition and then the acquisition of a major competitor. I mean, did either of these transactions kind of think -- changed the way you guys are thinking about the business or even your strategy going forward?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Well, we've always been opportunistic on builder acquisitions. Although in the past, they've always been smaller acquisitions to enter a new market. We continue to be focused on those opportunities as we evaluate a couple of new markets that we're interested in. With respect to the land side of the business, we already have our Gibraltar joint venture with PIMCO, which is a $400 million land fund that provides land banking services to many builders, and we just closed our first deal with that PIMCO fund with -- on some Toll land. But we are also evaluating the opportunity to create or acquire an off-balance-sheet land fund or land company that could give us the vehicle to efficiently, with a great ROE, feed land back into Toll Brothers. And those discussions will continue.

Operator

Your next question comes from Robert Wetenhall of RBC Capital Markets.

Robert C. Wetenhall - *RBC Capital Markets, LLC, Research Division - MD in Equity Research*

It's nice to see you guys diversifying geographically, diversifying product and reaching your targets. On the heels of a big victory, you guys were talking about ROE coming in ahead of your expectations. You were at 12%, then 12.5%, then 12.7%. Maybe it's for Marty, what kind of headroom do you have to drive ROE higher? If you're thinking about 2019 or 2020, what are the primary levers you're going to be pulling? Where do you think that number can go?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So Bob, thanks for your commentary. We appreciate it. As we look at ROE, we're really focused on what can we do and kind of commit to internally here over the next 12 months with an eye towards continued improvement. If you recall a year ago, when we set the 12% target, we had hinted to 50 to 100 basis points beyond that in subsequent years. Well, we chewed into a lot of that subsequent year goal already, and it makes it harder to set the goal equally as high going forward. So I think we're looking at somewhere in the neighborhood of 25 to 50 points, absent tax reform or significant joint venture formation here in this year. Beyond that, we'll continue to structure the balance sheet and the company so that we can focus on improving ROE while balancing gross margin.

Robert C. Wetenhall - *RBC Capital Markets, LLC, Research Division - MD in Equity Research*

And what's going to be the big lever for you? Is it going to be buybacks? Or where do you -- what's going to be the lever that gets you up there? Is it just a combination of multiple things?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

It -- I think it could be buybacks, it could be joint ventures. It could be improved income. It could be reduced taxes. There's a whole series of events that we could look at over the course of the next 12 months. And beyond that, it's just a continuation of all the initiatives we opened the call with.

Robert C. Wetenhall - *RBC Capital Markets, LLC, Research Division - MD in Equity Research*

Got it. That's very encouraging. Wanted to ask you if you could frame up the quarter for me. It seems like some big-dollar, high-margin projects are getting shifted out of 4Q into 1Q. It seems like you're still extracting great margins out of California. How do we think about California and West Coast margins on a longer-term basis? Like, 28.4% is pretty awesome. Where does that go in the next 2 to 3 years? And how should we think about that piece of the business in terms of profitability?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Bob, I think we're pleased to give you a margin guidance for the next year. And we're going to limit it to that.

Operator

The next question will be from Susan Maklari from Crédit Suisse.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

You guys have seen a nice improvement in your absorption pace this year, even with community count being relatively flat. As we think about that growth in communities coming through next year, can you talk about how we should think about the absorptions moving with that?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So we're pretty happy with the 3-unit increase we had this year, that's more than 10%. I don't think we'll see something quite that sizable next year. The market will dictate, while we hope it goes up modestly.

Susan Marie Maklari - *Crédit Suisse AG, Research Division - Research Analyst*

Okay. And then as we think about you almost coming up to the anniversary of launching the T Select product, can you talk to maybe some of the things you've learned with that? Or is there anything that's been different than what you had expected? And can you perhaps leverage some of that into some other markets or other product areas that you have out there that you weren't maybe initially thinking about?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure. T Select is -- exists as a brand in Houston and Philadelphia. It is a millennial-focused product line as I've mentioned on this call. It's our 3 Series Toll Brothers home. So it is still luxury, albeit smaller and more affordable, to attract the leading edge of the millennials who are buying homes later and therefore wealthier. But for the moment, let's forget the T Select name and just think about that buyer. We are selling homes to that buyer in many markets around the country. The Boise market, as an example, is very much driven by an affluent millennial. Jacksonville, Florida is driven by an affluent millennial to some extent. We have townhomes that are doing extremely well in Ann Arbor, Michigan, which is that buyer demographic, et cetera. So whether it is branded T Select or whether it is Toll Brothers branded communities that are just designed for the leading edge of that demographic, you will see more and more of it coming out of us. I think the one thing we've learned with new product is that we need to have models opened and decorated before we open the community because the buyer wants to see it and walk it and -- before they buy. And so it's harder out of a sales trailer to presell. And so just strategically, we will be opening those communities from decorated models going forward. That, I think, is probably the #1 thing we've learned...

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think one of the other things is that as much as we somewhat direct this to the younger buyer, we are seeing more than we expected from the move-down, slightly older buyer.

Operator

The next question will come from Megan McGrath with MKM Partners.

Megan Talbott McGrath - *MKM Partners LLC - MD & Co-Director of Research*

I just wanted to follow up a little bit on your City Living comments. As you mentioned, you have been talking about some of the sort of weaker conditions in the very high end. But just wanted to follow up on that a little bit versus what maybe you were seeing in the market at the beginning of the year or 6 months ago. Has it shifted at all? Has it deteriorated? Are we sort of steady Eddie versus what you were seeing a few months ago?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

It's steady Eddie, and we're pleased with our -- as I mentioned, our continued sales over in Jersey City. And we're very pleased with the new opening we had last month. The end -- actually, the end of October now, at Leonard Street down in Tribeca. And that, what we've learned is in New York City, if you're $2,000 a foot in a good location, you're going to do pretty darn well, and we are. And if you're at $800 to $1,000 a foot in Hoboken and Jersey City, you're going to crush it, which we have over the last year in both locations. So I think we're positioned really well, and I'm feeling good right now about the market, based on those buildings I just mentioned to you.

Megan Talbott McGrath - *MKM Partners LLC - MD & Co-Director of Research*

Great. And just a quick follow-up. I know you talked about the I-joist issue in the cancellations. And just wanted to make sure, obviously, you saw a decent decline year-over-year in closings in the North. Was that also due to the I-joist issue? Or was that sort of a community count decline thing as well?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Yes, it was both the I-joist and a declining community count coming out of the north.

Operator

Our next question will be from Nishu Sood with Deutsche Bank.

Nishu Sood - *Deutsche Bank AG, Research Division - Director*

Just wanted to ask a little bit, dig into the math on the gross margin decline for '18. Of the 80 basis points, I think your -- you broke out the 50 basis points that was going to come out from City Living. The remainder that is going to be driven by the California erosion, I just wanted to understand that a little bit better. Your sales pace in California is at about 2x pace the rest of the company. So I would have thought, even with some erosion of California gross margins, there might have still even been a positive effect. It seems to imply that the closing pace in California is not going to be as high as that kind of 2x order pace. I was wondering if you could help me reconcile that, please.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think you've done a bit more precise math than we've chosen to get into in trying to categorize a couple different reasons. So I guess I would say don't doubt your math.

Nishu Sood - *Deutsche Bank AG, Research Division - Director*

Okay, okay. All right. And second, I just wanted to ask on active-adult. You've been talking about that as a growth priority. Obviously, there's been tremendous, great growth in that, up to, I think, 19% last year of closings. What did you come in at this year? And since you're still talking about the growth ability of that division, where could that go in the coming years?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Hold on one second as Gregg pulls the numbers together. So 2017 Active Living, which is our 55 and over business, was 19% of units. And for '18, it's projected to be about 20%.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

But there are a number of markets where we don't have that product offered and we are looking to find land for the product.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

And we have a number of locations where the land is controlled and significant communities that will come through in '19. So this is a growth business based on the land that we control and some of the deals that we're playing with, and the appetite.

Gregg L. Ziegler - *Toll Brothers, Inc. - SVP and Treasurer*

Thinking the California deals and the seniors deals that we looked at yesterday coming through the pipe.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Right.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Right.

Operator

The next question will be from Stephen Kim with Evercore ISI.

James A. Morrish - *Evercore ISI, Research Division - Analyst*

It's actually Trey on for Steve. With respect to land, what was the total dollars spent in the quarter for acquisition development? And how are you guys thinking about new land going into 2018? Do you think about your land spend is going to keep up with the revenue growth that you're expecting? Or do you think you'll grow a little bit faster, a little bit slower, given how you're looking to continue to shift to more options?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Gregg, what was the number for the fourth quarter?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

It's $380 million

Gregg L. Ziegler - *Toll Brothers, Inc. - SVP and Treasurer*

Yes. Q4 '17 land spend was $192 million; and then improvement cost, another $163 million; and some soft costs gets you into approximately $380 million for the quarter.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

And with respect to '18 land spend, we're opportunistic. We will spend as much as we need on the good deals that are presented to us. But I would say with the company growing and with our appetite, I am hopeful that the land spend will increase in '18.

James A. Morrish - *Evercore ISI, Research Division - Analyst*

Okay. And then turn to City Living for a bit. I know you guys have been quite successful here in the greater Manhattan area and then down in Maryland. But how has the continued prospecting out for new buildings or new types of developments in other cities gone over the past 3, 6 months?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

So we have 2 properties in greater L.A. that we control and are excited to launch City Living in the L.A. market. We're continuing to look in San Francisco, Seattle, Miami, Washington, D.C., Boston...

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Philadelphia.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Philadelphia. We have a pretty cool opportunity in Philadelphia that we're negotiating on right now, plus a second property we control that we're going through the entitlements on. So I continue to be hopeful that the City Living brand will be bigger and be more geographically spread.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So just a follow on that term, control. Control often means we still have diligence points to get through or approvals to get through. So just because we control it doesn't necessarily mean we're going to execute on it.

Operator

Our next question will be from Mike Dahl with Barclays.

Michael Glaser Dahl - *Barclays PLC, Research Division - Research Analyst*

I had a question just first around tax reform. And more philosophically, if you think about the corporate rate potentially going permanently lower, how do you think that affects land purchasing decisions? Do you really think that builders will fundamentally harvest more cash and returns out of the existing business? Or do you think, especially in more land-constrained markets, you effectively have some working that into higher land prices?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Mike, we'll have to see how it plays out. We're certainly not approaching tax reform as an opportunity to pay more for land...

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Or reduce margin.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Or reduce margin. It's a competitive market, buying land. We are -- sometimes we get lucky and we're the only ones talking to a seller. But in most cases, sophisticated sellers are running a process or talking to a number of different buyers. And that competitive environment dictates how we do, subject of course, to making sure we're not diluting margin. So...

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think the tax theory is that reducing the rates will lead to more growth, more jobs, an improved economy. And whenever those factors come together, the housing prices seem to go up and us builders are in a better position.

Michael Glaser Dahl - *Barclays PLC, Research Division - Research Analyst*

Got it. Secondly, just a -- I know this is relatively small, but the decision to on-balance sheet the rest of the Sutton. Can you talk about just what was driving that decision to finish out the project yourselves?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think some of the reasons we look at a joint venture are because there's construction risk, there's development risk, there's marketing risk, there's execution risk. We took most of those risks off the table as the building got built and 3/4 sold and delivered. And we just said it's strategically important for the partner to get cashed out and improve their return on equity and their IRR. And it's pretty good for us because we get a good gross margin and we put it on balance sheet. So it was a win-win as we looked at it in a different timeframe or piece of the development cycle than at the outset.

Michael Glaser Dahl - *Barclays PLC, Research Division - Research Analyst*

Okay. Got it. And if I could sneak one quick one in. Marty, you mentioned the 3 units that were expected to close in 4Q. I think all of those are concentrated at 1 project. My understanding was there's -- potentially 2 of those 3 haven't been actually sold yet. Could you just give us an update on those units? Have they been sold? Are they in backlog? Or how should we think about timing there?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

It's 2 different projects and all 3 units have been sold and all 3 are expected to settle in the first quarter. So...

Gregg L. Ziegler - *Toll Brothers, Inc. - SVP and Treasurer*

Two by the end of this week.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Two by the end of this week. I'm looking at Rick Hartman here to see how confident he is in that, and he's nodding his head up and down.

Operator

The next question will be from Mark Weintraub with Buckingham Research.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Just a couple of follow-ups. One was, would it be possible to get a breakdown of your deliveries for fiscal '17, how much came from optioned versus owned lots?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Well, by the time we begin construction on the lot, we own it. So at some point, everything's an optioned lot because we had it in diligence and we haven't closed on it. So we control it once we've put it under contract even if the diligence period hasn't expired. So that's a really challenging question for us to answer in the manner you want us to.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Kind of direction, just trying to get a sense. Is that 80-20 where you went from to the 65-35? Is that sort of, maybe with the 80-20, have been more indicative of the type of underlying ownership of the lots at the relevant times?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I'm going to say we just don't know. So I don't want to hazard an estimate or a guess.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Sure. And then second, just on JV and other income. I know you've still got that interest in the hotel in Brooklyn Bridge Park. Is that included in the guidance for '18? Or is that something that could provide upside if that were to come to pass?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

There's a moderate level of operating income, but not a transaction gain.

Mark Adam Weintraub - *The Buckingham Research Group Incorporated - Research Analyst*

Okay. Great. Then lastly, you mentioned that you're beginning to -- that you're evaluating now opportunities to create an off-balance-sheet land development investment. How recent is that, that you've started to kind of look at that possibility? Is that something you've been doing for a while? Or is this more with what's been going on, you've focused on it more?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think we've always had it as something we've considered. But I think -- and the industry has looked at that type of structure for decades. But a couple of the recent transactions, as mentioned earlier, have heightened our interest in it and given us the, I'll say, more optimism that we may be able to get something done.

Operator

The next question is from Jack Micenko with SIG.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

Curious what percentage of communities in the quarter you were able to push price on. And then if you'd maybe frame out maybe some regional relative leaders and laggards on the pricing side.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

One second, Jack. While Gregg is getting specifics, the leaders are out West. We've had the most pricing power in Southern California, Seattle, Northern Cal, Reno, Michigan. Believe it or not, Boise has had nice pricing power. And a smaller market for us, Orlando, would round out that list of the most pricing power.

John Gregory Micenko - *Susquehanna Financial Group, LLLP, Research Division - Deputy Director of Research*

And then while he's looking, I get another follow-up. I know Terrapin Row, I know -- and it's not a big business for you guys, overall, but want to understand that more. Was that more of a financial decision? Or was that more strategic? How do we think about the student housing prospects in line to that sale?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Our partner in that property, who had 75% of the equity, was inclined to sell after full stabilization. We got the highest price, I believe, ever, for a student housing property. We ran a process and sort of had a number in mind that if we hit it, we go, and we beat it. So it was a great return and very, very good income to Toll and a very happy partner. And as we said all along, some of the apartments, whether they be student housing or market, will be held long term and some will be sold at stabilization. And that was one that was performing very well. It was 99.9% occupied, which I think 1 -- that means 1 bed out of 1,400...

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

1,492 out of 1,493.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Was not taken. And that's the story behind that one.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So our business mentality, strategy for the apartment business remains the same. If we build 3, we'll probably sell 1. And sometimes, that sale is a portion of our interest and sometimes it's 100% of our interest. So that will be a 2018 first quarter gain that we've projected in the $40 million of guidance we've given you for the first quarter JV and other.

Operator

Our next question comes from Jade Rahmani with KBW.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of construction efficiency, I was wondering, is there an opportunity to further increase the amount of off-site integrated work you guys already do?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

So we have 4 panel and truss plants that serve the Mid-Atlantic, the Northeast and the Midwest. We are certainly, as all the other builders are, evaluating some of the new startup companies that are talking of robotics and much more of the home produced off-site. We've met with a few of those providers, and it may come to the industry over time. We don't see anything today that's a game-changer. Frankly, we haven't seen much yet that is all that better or more sophisticated than the 4 plants that we've had for a long time. Transportation in our industry is a big deal because you're not moving computers or refrigerators on a truck, you're moving parts of houses on local roads and highways. And for the moment, very little has changed. And I think it's going to take some time. But it's certainly an interesting time in our industry because there appear to be more and more tech companies that are experimenting and trying to figure out how to make it work. So we'll be on top of it, and one day, but not today.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

In terms of the amount of JV income, could you quantify what proportion comes from City Living? And what the other, whether it be land joint ventures, Gibraltar, what the other contributions are?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

For 2017? Do you have that, Gregg? I don't have it off the top of my head. I know $22 million is the apartment business, consisting of roughly $27 million of gains on transactions and $4 million or $5 million of overhead as we build out the rest of the business. We have -- how much was the other income, which is just kind of routine? I got it here, too. $53 million was just the title insurance and kind of internal subsidiaries. The JV and other, the vast majority last year was associated with our Pierhouse project that was nearly $63.5 million. We made $8 million at the Sutton -- $8.5 million at the Sutton before we put it on balance sheet. And those are the biggest components of the other -- of the JV. And the other, our title insurance business, which is a pretty good run rate business, you can kind of count on this, that should grow as we grow, was around $13 million of income. And then management fees for some of the joint ventures was close to another $10 million -- actually, $13 million. And then $5 million of retained customer deposits on cancellations. So a pretty healthy year, and we're well on our way to replacing that sizable set of income from the Jupiter -- I'm sorry, the Pierhouse project. And a lot of that will come from the apartment business that I said is going to double next year.

Jade Joseph Rahmani - *Keefe, Bruyette, & Woods, Inc., Research Division - Director*

And in terms of supply dynamics, when do you anticipate peak deliveries for the market in New York City? Is it 2018 to peak? Or 2019, do you think?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Well, I think that all depends on whether we find new projects. And we do have a couple that we have under control right now.

Operator

The next question will be from Ken Zener of KeyBanc.

Kenneth Robinson Zener - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

So your -- question I have is on SG&A at 10%. With your Res guidance where it is, it seem -- would -- can you talk to your variable costs, if that's staying the same? Because if it is, it seems like your fixed cost in communities is going up quite a bit. And can you expand on that?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Well, I think we continue to see our investment in our sales team and in our model homes pay dividends in terms of our top line growth. And we mentioned earlier that we continue to make investments in the G&A line for our technology initiatives. But I think overall, G&A as a percentage of revenue is going to be a bit flat, whereas the sales component is going to go a bit up in terms of -- I'm sorry, what are you saying there, Gregg?

Gregg L. Ziegler - *Toll Brothers, Inc. - SVP and Treasurer*

So in terms of absolute dollars or S next year versus this year. In absolute dollars. Yes.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

Fine, fine. Absolute dollars, S is going to go up, right? Okay. Thank you.

Operator

The next question will be from Will Randow with Citi.

Will Randow - *Citigroup Inc, Research Division - Director*

Congrats on the progress as well as timings on the buyback. So I was hoping to bridge the gap between 2 or 3 different data points. Specifically first you mentioned (inaudible) was nearly as strong as 2005, and I'd love to hear your feel about the absorption versus price today. Conversely and secondly, the last time you saw this kind of bump up in cancellation rate was the first fiscal quarter of 2006. And obviously, your margin expectations are a bit lower for next year on the pretax basis. So I guess, can you help me bridge the gap between those 3 data points? As well as give a letter grade for each of your markets as Bob used to do?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

I think the cancellation rate we mentioned earlier is entirely attributable to the I-joist issue, where of the 350 impacted homes, we had cancellations on roughly 10% of them. That all happened in the fourth fiscal quarter. In addition to that, we had 20 buyers swap lots. We didn't count those as cancellations and we didn't count those as new sales. I think we've gotten away from the letter grades and we'll stay away from the letter grades, but maybe Doug wants to make some comments on some of the healthier markets.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Sure. Without letter grades, I can give you the As. There's no slow business. There's no snow right now in Colorado. Southern Cal, I mentioned, very hot. Northern Cal, very hot. Seattle, we're actually putting houses on the market in Seattle with a recommended bid price and letting the buyers submit a sealed bid, take it higher than our price sheet. Las Vegas, very strong. Reno, very strong. Northern Virginia, comeback. It was slow to recover and now it's clicking, one of our hotter markets. New Jersey has broken into the top 5. And New York City Living, on absorptions, actually leads the company because of some of the success we've mentioned on this call at our new openings and over in Jersey City. So I could add a few more, Pennsylvania has done very well. Colorado has done very well. Michigan has done very well. So there's a nice handful or more of some highlighted markets that are doing A-level work.

Will Randow - *Citigroup Inc, Research Division - Director*

Lastly, do you have a plan to reduce the amount of debt outstanding in the next couple of years? Or are you okay with the current notional outstanding of little over $3 billion? And I guess also, can you skim over tax reform carve-outs for real estate?

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So I don't think we have any particular plans with respect to debt. We'll evaluate where rates are when debt matures. Right now, we enjoy a 35% or so, 34.5% net debt to cap ratio, and our mix of long-term and variable-rate debt gives us lots of room in our weighted average maturity and our weighted average interest rate. We're pretty happy with those things right now. What was the last question, Will?

Will Randow - *Citigroup Inc, Research Division - Director*

In terms of carve-outs for real estate in regards to new tax reform.

Martin P. Connor - *Toll Brothers, Inc. - CFO and SVP*

So as we look at our interest as a percentage of, I guess, pretax income, we have quite a bit of room to go before we bump up against the carve-out of 30% of -- interest can only be deducted up to 30% of your pretax income. So we're comfortable with that.

Operator

Ladies and gentlemen, this concludes our question-and-answer session. I would like to turn the conference back over to Doug Yearley for any closing remarks.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO and Director*

Thank you, Chad. Thanks, everyone, for listening in and for your support. Have a wonderful holiday season. And we'll see you in the new year.

Operator

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