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TOL - Q4 2018 Toll Brothers Inc Earnings Call

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Good afternoon, and welcome to the Toll Brothers Fourth Quarter 2018 Earnings Conference Call. (Operator Instructions) Please note, this event is being recorded.

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

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Thank you, Anita. Welcome, and thank you for joining us. I'm Doug Yearley, Chairman and CEO. With me today are Bob Toll, Chairman Emeritus; Rick Hartman, President and COO; Marty Connor, Chief Financial Officer; Fred Cooper, Senior VP of Finance and Investor Relations; Kira Sterling, Chief Marketing 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 DYearley@tollbrothers.com.



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In fiscal year 2018, we produced the highest revenues, contract value and earnings per share in our 51-year history. In addition, our net income, home deliveries, contracts in units and year-end backlog in both dollars and units were the highest in over a decade. Our return on beginning equity grew from 12.7% to 16.5% in 2018 and our fourth quarter revenues, net income and earnings per share were the highest for any quarter in our history.

Despite a healthy economy, we are seeing a moderation in demand. Fourth quarter contracts declined 15% in dollars and 13% in units compared to a difficult comp from 1 year ago. Fourth quarter demand flowed to a per community pace more consistent with fiscal year 2016's fourth quarter, which was still strong.

In November, we saw the market further soften, which we attribute to the cumulative impact of rising interest rates, rising home prices and the effect on buyer sentiment of well-publicized data of a housing slowdown. We saw similar consumer behavior in late 2013 when a rapid rise in interest rates temporarily tempered buyer demand before the market regained momentum.

Positively, we have seen Internet traffic at all-time highs and have maintained consistent traffic-to-agreement and deposit-to-agreement conversion ratios. California has seen the biggest decline. Per community contracts declined from 10.4 in fiscal year 2017 fourth quarter to 5.8 this fourth quarter. 5.8 was still above the company average.

Significant price depreciation over the past few years in California, fewer foreign buyers in certain communities and the impact of rising interest rates all contributed to this slowdown. But California is the world's fifth largest economy with diverse job creating industries, including vibrant technology companies, a large concentration of wealth and a very desirable lifestyle. With our attractive coastal California land, our leading brand and the state's constrained supply of housing, we continue to believe in our position in the California market.

Backlog in California was up 26% in value at fourth quarter end compared to 1 year ago. Most of this backlog will be delivered in fiscal 2019 at a projected gross margin above the company average.

There are many positive factors underpinning the broader U.S. economy that we believe are supportive of the housing sector longer term and our affluent markets particularly. Household formations are increasing. The economy is growing. The nation is experiencing the lowest unemployment rate in many decades, and consumer confidence is near an all-time high.

In the past few years, many of our customers have enjoyed wealth creation through the stock market, home price appreciation and salary increases. Additionally, the homebuilding industry's fundamentals appear solid. New home supply remains constrained. Industry-wide production of single-family homes is projected to be approximately 865,000 in 2018. This compares to 1.8 million at the last peak in 2006 and the long-term average of 1 million single-family homes since 1970.

30-year mortgage rates remained quite low compared to historical norms and have come down a little bit in the past few weeks. And the 30-year jumbo rate is currently about 0.375% below the conforming rate. The credit policies of mortgage lenders are much more disciplined than in the last cycle. These restrictors on supply are in contrast of the last cycle when overbuilding, easy mortgages and buyer speculation resulted in a massive oversupply when the market softened.

Equity in existing homes is at an all-time high, providing significant liquidity for current homeowners, who want to upgrade to a new home. The average age of the stock of existing homes in the U.S. is nearly 40 years, its oldest ever. As the only national homebuilder focused on the upscale market, Toll Brothers homes stand out against these older homes. We offer designs for today's lifestyle, integrated technology, energy efficiency and ease of maintenance.

As a reminder, we build comparatively few spec homes. Therefore, we are not burdened by having a large number of completed unsold homes on the market. Our average buyer adds are over \$160,000 in structural and designer options and land premiums. And on average, our homes in backlog carry a nonrefundable deposit of approximately \$70,000.



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For those affluent customers, who choose to rent instead of buy, we have our Toll Brothers Apartment Living brand with a development pipeline of over 15,000 units. In fiscal year 2018, we recognized \$56 million of pretax profit from this business, generating cash through property sales, recapitalizations, development and management fees. This is a great standalone business and even better serves as a complement to our for-sale homebuilding business. With over \$2 billion of liquidity at fiscal year end, we can pursue M&A opportunities, opportunistically acquire lands that may become more attractively priced, pay down debt and buy back stock, while still maintaining a conservative and low leverage balance sheet.

We enter fiscal year 2019 with a tremendous brand, a broad geographic footprint and diverse product offerings, a well-located land portfolio in high-quality markets, substantial liquidity and a strong balance sheet. With the broader economy healthy, we plan to continue to pursue growth as we expand and diversify the products we offer to the upscale residential market.

Most importantly, we have a tremendous team of Toll Brothers associates, who made fiscal year 2018's record results possible and are preparing us for a bright future.

Now let me turn it over to Marty.

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

Thanks, Doug. Before I address the specifics of this quarter, I do want to note that a reconciliation of the non-GAAP measures referenced during today's discussion to the comparable GAAP measures can be found in the back of today's release. Compared to fiscal year 2017, our full year net income and earnings per share rose 40% and 53% on a revenue rise of 23%. Our contracts increased 11% in dollars and 4% in units, and our backlog rose 9% in dollars and 4% in units.

In fiscal year 2018's fourth quarter, net income rose 62% and our earnings per share rose 78% on a revenue rise of just 21%. We are pleased with our fourth quarter and full year earnings. They exceeded our expectations and guidance, supported by growth in average delivered price, improved SG&A leverage and favorable tax results. Q4 adjusted gross margin was strong, but came in below our guidance due to a delay in collection of some state brownfield cleanup credits, product mix, modest cost creep and slightly higher outside realtor commissions. The improved Q4 SG&A leverage reflects increased revenue and good cost control.

Our Q4 tax results were helped by reserve releases associated with settlements and statute expirations as well as some state tax planning. We have grown revenues at a compound average annual rate of 25% since fiscal year 2011, while maintaining a disciplined strategy of land acquisition and balance sheet management. We continue to focus on increasing the percentage of our land held in options rather than owned and at fiscal year-end 2018, our option land represented nearly 40% of total lots controlled and owned compared to 30%, 2 years ago.

We remain focused on liquidity, low leverage and long-term -- long-dated maturities of our debt. We ended fiscal year 2018 with a debt-to-capital ratio of 43.7% on a gross basis and a net debt-to-capital ratio of 33.2%, both compared to 41.5% and 34.5% at fiscal year 2017. Our net debt-to-capital ratio is down 690 basis points from just 3 months ago. We had more than \$2.3 billion of untapped cash and available credit facilities.

On November 1, we extended the maturity of our term loan to November 1, 2023. We increased that facility from \$500 million to \$800 million and reduced the interest rate by 10 basis points. On November 30, we retired \$350 million of 4% senior notes. Today, our weighted average debt maturity is 5.4 years, our weighted average interest rate is 4.62% and we have only \$250 million of maturities in the next 39 months.

Our book value per share at 10/31/18 was \$32.57, our highest ever. It's up from \$28.82 a year earlier, and it has doubled since 2012. With a favorable liquidity position and the strength of our balance sheet, we are positioned to take advantage of land opportunities, make acquisitions, reduce our debt or invest in our company through further share repurchases.

With respect to share repurchases, we have made good progress in reducing our share count. Q4 2018's weighted average share count was approximately 149.6 million shares, down 9% from 2 years ago. With the recent softening of demand that Doug mentioned, we believe we will likely see some relief on the labor front. While it is still early, we expect to see some softening on labor pricing and increased availability in some



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of our markets. We are actively rebidding jobs with the goal of reducing our cost. Additionally, lumber costs are much lower today than they were earlier this year.

These current market conditions create a wide range of possible scenarios for our full year results. While we are targeting modest community count growth in fiscal year '19, we have limited our forward-looking income statement guidance to the first quarter of 2019. For that first quarter, we expect deliveries of between 1,350 and 1,550 units with an average delivered price of between \$850,000 and \$880,000. We expect gross -- we expect adjusted gross margin of approximately 23.5% and SG&A as a percentage of first quarter revenues of approximately 13.1%. We expect other income and income from unconsolidated entities of approximately \$30 million and a tax rate of approximately 27.5%. Lastly, we expect our weighted average share count for the first quarter to be approximately 149 million shares.

Now let me turn it back to Doug.

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

Thank you, Marty. Anita, we are ready for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) The first question today comes from Stephen East with Wells Fargo.

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

Doug, I'll start with what everybody is focusing on right now and that's the order front. Could you do 2 things? One, talk about what you are seeing through the quarter, maybe in California, if you could parse it out a little bit for us and the Mid-Atlantic and South slowed for the first time, so that surprised us a bit? And then when you say November worsened and just maybe a little bit of expansion of thoughts on that as well?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

Sure, Stephen. Let me try to cover it for the company, I think, that will be most helpful. So as we said in our release and as I said in my prepared comments, November has shown some further softening. I just want to remind everybody that a couple of years ago, we got out of the business of providing specific data points on the first month of the new quarter that was leading into our calls, because it proved not to be a reliable indicator for the full quarter results. But with that said, the trend throughout the fourth quarter was that September was better than August and October was better than September. But I wouldn't read too much into that since that trend that I just mentioned has not and did not continue into November.

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

Got you. Got you. Okay. And then as you look at California, what do you think was really driving that there? Do you think that was -- how much of that do you think was the international buyer stepping away versus true fundamental demand taking a pause there?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

Yes. So I think there are 3 factors in California. There has been significant price appreciation over the last couple of years. We certainly have had fewer foreign buyers in specific communities and then of course layered on to that was the rising interest rates. We sold over 10 homes per quarter



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last year, and we knew that was not a number that could be continued. As I mentioned in my script, Northern and Southern Cal are still above the company average for sales. The foreign buyer most impacted our Orange County communities, and it certainly had a significant impact there. But it had a much -- and that's the Chinese buyer, specifically. It had much less of an impact in LA County and up around San Francisco. Long term, we really like California. As I mentioned, it's the fifth largest economy in the world. And most importantly, we love our land holdings and the great brand we've created out there with how we operate it.

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

Got you. Okay. And then switching gears a little bit, you've got \$1 billion plus on your balance sheet. Can you help us out about how you're thinking about share repurchase in 2019 and probably more importantly, thinking about your land spend and has the land market changed any? And how does it fit into 2019 land spend versus 2018 land spend?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Stephen, it's Marty. We always run our business for the long-term. And as you mentioned, we currently have a very strong balance sheet and ample liquidity. So we can afford to be patient in the market like this. We'll carefully monitor the developments and continually access all our strategic alternatives, including the ones you mentioned, debt reduction, stock buyback, land purchases or dispositions and builder acquisitions. We're going to be observant, diligent and flexible, but I don't think in light of where we are in the seasonality, you're going to see us make any dramatic changes.

Operator

The next question comes from Alan Ratner with Zelman & Associates.

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

So this might be a bit of a continuation on the last one, but you mentioned a wide range of possibilities as far as how '19 could unfold at this point than at the same time, this is a business that requires a lot of kind of very forward-looking thinking as far as land purchases, development, pricing strategies as you open up some new communities and it looks like you opened a quite a few this quarter and expect to grow that a bit next year. So can you share with us a little bit kind of right now what your base thinking is how '19 does unfold, obviously the guidance is not looking for specific guidance, but do you envision a reacceleration similar to what we saw back after the taper tantrum in '13? Or are you actually may be ratcheting back some of the land buying and personal hiring decisions with a bit more conservatism, given how far things have gone in the pricing side?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

So Alan, it's business as usual here. We continue to buy land, we continue to look at M&A opportunities. At the same time, we are very focused on specific markets, the amount of land we have in certain markets and the underwriting of each individual land deal changes based on its location and how a specific market is performing. I'm not here to predict how long these current market conditions will continue, except to say that it just doesn't feel like a slowdown that will have a long duration because of the fundamentals are strong both with the macro U.S. economy and with the housing business. So we'll continue to do what we do well, which is to be conservative and thoughtful on our land buying but we are absolutely still in business and still operating as we have in the past.



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

That's helpful. If I could do a follow-up here, you made a comment Doug, I think in your prepared remarks about the mortgage, the quality of the mortgage that is being done today and how it's much better than the prior boom period. A few weeks ago, the FHA put out their annual audit and I know FHA is not a big part of your business, but presumably your home buyers are selling their homes potentially to FHA borrowers. And one of the things they flagged in there was the significant increase in high DTI, high back-end DTI loans and voiced some concerns about that and we've seen similar trends with the GSEs as well. So have you -- I'm curious if you've looked at that data for your buyers. Obviously, you have a lot of cash buyers, high down payments, but have you seen any uptick there that would suggest from an affordability perspective, things are getting a little bit more stretched? Or is there any other color you could provide just on the mortgage environment that might give you some pause or concern?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Sure. I'm going to hand this off to Don Salmon, who runs our mortgage company. Don, why don't you just start with the percent of cash buyers, the loan-to-value with those that get a mortgage and then roll right into Alan's specific question.

Donald Salmon

We are about just short of 25% cash buyers right now, and our average loan-to-value across all the product lines for the year was 68%. So I mean, that start's, I think, with a pretty strong buyer base. When you look at our ratios, our income ratio, they've been pretty steady throughout the year. I'm looking at a chart now where there has been almost no creep at all in the ratio that the buyers -- that our buyers see. So we also went back in the last week did a little study on people who are prequalifying and the fall-out rate of those, and it's virtually unchanged. There is no material change in that number at all. So it's not a material -- there is not a material impact for us at this point.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

FHA.

Donald Salmon

FHA, the question of FHA was the percentage of our buyers?

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

About 5% overall.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

5% FHA.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Alan, the other thing I'd add is, we've actually -- in '17, our loan-to-value for the year was 70% and our cash buyer percentage was 21.8%. So Don mentioned close to 25% cash buyers this year and a loan-to-value at 68%. So our data is going in the opposite direction of the question you asked.



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Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

And 50% of our active-adults are empty-nester, move down baby-boomer buyers are all cash. So as that business grows for us, we have more cash buyers there.

Operator

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

John Lovallo - BofA Merrill Lynch, Research Division - VP

The first one, Marty, your comments on the potential for the labor market loosening up a bit, I think it's pretty encouraging. But just looking at your 1Q delivery guide, I think the midpoint would kind of imply flattish year-over-year units and about a 50 basis point decline in the backlog conversion ratio and the high-end, I think, would imply kind of a flat backlog conversion ratio. So the first thing that we thought of that maybe you were seeing some more construction delays or something along those lines. Can you help us kind of reconcile that?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

I think it's a function of the extended backlog that has developed and timing that has developed over the course of this year. In my comments, I mentioned that, that labor benefit in terms of availability and pricing, we are just starting to see the pieces of it. You're generally going to see the pieces of it start with the front-end trades and roll to the back-end trades. And our first quarter deliveries are really dependent right now on the back-end trades.

John Lovallo - BofA Merrill Lynch, Research Division - VP

Okay. That's helpful. And then this is more a kind of a higher-level question here, but I mean there is certainly a lot of talk about Amazon moving into Virginia and into Long Island City. You guys have a presence in both of these locations. I mean, how are you thinking about the potential impact over the next, call it, 5 years or so?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

John, we are excited to have a large operation in Northern Virginia, in Maryland and a large and growing apartment business in Washington D.C. proper. So that aligns great with the Northern Virginia, Amazon headquarters. We, of course, also have a significant presence in New York. We're not in Long Island City, but we're looking all over that area. So I think it's going to be great for the homebuilding operation, and it's going to be great for the apartment business.

Operator

The next question comes from Nishu Sood with Deutsche Bank.

Nishu Sood - Deutsche Bank AG, Research Division - Director

I wanted to ask about the demand weakness and the potential response you folks might have in terms of price. If you look historically, you folks, I think, arguably have been more cautious than your peers. Obviously, out of a need to protect the great brand you have and the longer backlogs you have as well. We may not even be at the point yet where we are talking about price discounts, but if the market continues to develop this way, how should we expect your response to be kind of compared to prior cycles?



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Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

So Nishu, as you know, we don't run this business quarter-to-quarter. We run it long term. In good markets and bad markets, we are always focused on pricing at the community level, and we always, no matter what the market condition, decide what to do with incentives to generate sales. And right now, there is not much different we're doing from what we've done 6 months ago or a year ago. Our incentives in the fourth quarter were up, I think, a modest \$5,000. And it's also different from the auto industry where it's apparently December to remember and lots of cars get sold and there's lots of incentivizing and deals. This is not the time of year when there is a lot of houses sold. And so we are continuing business as normal, and we will roll into the new year and continue to evaluate community-by-community and make those decisions that are needed to be made to continue to sell houses.

Nishu Sood - Deutsche Bank AG, Research Division - Director

Got it. Got it. Okay. And then second question I just wanted to ask was about the fiscal '19 guidance. Your longer backlogs have traditionally given the luxury of a little more certainty about providing guidance. And I think as far back as through the last downturn, you've had a fairly consistent pattern of providing at least a couple of forms of annual guidance -- the major metrics. So I think the lack of '19 guidance stands kind of in contrast of that. Certainly the market is nowhere near as bad as it was during the last downturn, not even close obviously. So how should we read that then, the kind of lack of some sort of -- some forms of guidance around '19?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

I think we're trying to be cautious, Nishu. I think our backlog does provide you some visibility. And I think we gave in the more recent years many more data points than we did in the past, and it was tough to come out with the guidance that would address some of your desires without addressing all of your desires.

Operator

The next question comes from Jack Micenko with SIG.

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

Marty, the year-over-year 1Q guidance looks pretty stable on gross. Is that mix? Or is that a sign of some of that cost control or cost pressure abating some of them? When does lumber -- the benefit of lumber come into your workflow into '19?

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

I think that Q1 guidance does not reflect the benefit of lumber yet. That will be to the late stages of the second quarter and more so in the third and fourth quarter of next year. I think the mix is definitely a component of this and some California deliveries as a benefit to that mix.

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

Okay. And then Doug, I guess, the message here is business as usual, but have your thoughts strategically changed at all around the multifamily side or city living high-rise? Some of the prepared comments in the past have maybe focused more on that. Just more curious if any strategic shift is going on in those other businesses mix.



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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

We continue to look for city living opportunities. We're excited to open a very small city living building in LA this coming year, and we have a number of other markets targeted nationwide to expand the business. We recently opened a new building in Jersey -- in Hoboken and then another one coming shortly in Jersey City, and we've opened a building in SoHo in the last couple of months. So city living is still moving forward and looking to hit a bunch of different cities around the country. We love the apartment business. We started it about 5 years ago, and we are now up to 15,000-plus units in various stages of development. That business started Boston down to Washington D.C. and has now expanded and diversified into a national business. And we will continue to grow that business, as we've mentioned many times, it is done off balance sheet with joint venture equity partners and some of the assets we hold long-term and others we sell at stabilization, and you will continue to see more of that. And I am very hopeful and confident that the Apartment Living business will continue to grow significantly.

Operator

The next question comes from Susan Maklari with Crédit Suisse.

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

My first question is just you noted in your comments, Marty, that part of the gross margins pressures you're seeing are some higher outside realtor fees. Can you just give us a little more detail on what you're seeing there? And how we should be thinking about that going forward?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I think it was pretty modest, and I think it was pretty concentrated to this particular quarter's delivery. It was driven by mix and some special volume-based incentives, some of the brokerage rate we will achieve.

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

Okay. And then I just wanted to follow-up on how should we be thinking about material prices for next year. I know lumber has come down a lot, but, I guess, as we think about maybe some of the trade dynamics that have changed here more recently, the potential for tariffs maybe rising coming off. How are you thinking about some of the input costs looking forward?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I think, Susan, that's part of the uncertainty we see in the environment and part of the reason we have not given a lot of guidance beyond next quarter. We have seen the threat of tariffs would be greater than the actual impact of tariffs to-date, but we don't know how long that may continue.

Operator

The next question comes from Stephen Kim with Evercore ISI.

Stephen Kim - *Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Housing Research Team*

Historically, you've talked about the fact that the spring selling season really is often a misnomer and it kind of gets going as early as January, and I was curious as to whether or not your view around your 2019 guidance, we could interpret as wanting to wait until you get into sort of January and see how January shakes out before you would go ahead and set some markers down. And then secondly with respect to the negotiations on labor that you have ongoing, just to get some order of magnitude. Should we be thinking that you may be able to have an opportunity to actually have reductions year-on-year in labor cost per unit? Or are we just simply talking about a slower rate of growth?



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Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

To your first question, Stephen, yes, the spring selling season is really a winter, early spring season. I think the name spring comes from the resale market, where the resales tend to kick in March, April and run through call it June, July. And in our business, it's Super Bowl Sunday or may be a week before, so call it, the third week of January, once everybody is back from the holidays and settled in through mid-April. And so yes, since most homes are sold during that period of time, we have decided it is best to wait and see how that season develops to be able to provide more definitive guidance. That doesn't mean by February 1, we have a clear picture because the month of February include in fact, president's weekend is usually the biggest weekend of the year is when we really get probably the most clarity on where the business is. With respect to -- Marty, go ahead.

Martin P. Connor - Toll Brothers, Inc. - Senior VP & CFO

On the cost front, I think certainly looks like lumber related cost will be a reduction year-over-year, but labor and material, I think, your comment to consider it as slowdown of increases is probably the right way to go. There may be some decreases in there in certain trades and in certain markets, but I think a slowdown of increases is the better way to phrase it.

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

And we're also hearing of a bit more availability from some trades. So that may be able to help us a bit on production cycle time.

Stephen Kim - Evercore ISI Institutional Equities, Research Division - Senior MD & Head of Housing Research Team

Sure, we'll take it. And then secondly T Select. I believe, we retired T Select and I was curious as to whether you could comment on what your thinking may be regarding targeting lower price points -- slightly lower price point homes across your company and sort of the longer-term view as to what's the best way to target that opportunity might be?

Douglas C. Yearley - Toll Brothers, Inc. - CEO & Chairman

Sure. So as we had told you, when we first mentioned the T Select name, we are going to test it in a few markets and we have decided after that test that it is best to sell all price points through the Toll Brothers name. Our sales teams were frustrated with the time they wasted in trying to explain to buyers and realtors what T Select meant, and we recognize that it can all be done through Toll Brothers without in anyway diluting the great Toll Brothers name and with making the sales process better. So we are still committed to offer communities at lower price points to primarily millennials. We'll just do it through the Toll Brothers name. Right now, 22% of our buyers are under 35 years old. So we are in that business and it is growing, and you will continue to see a nice mix of the move up Toll Brothers communities, the move down Toll Brothers communities through the empty-nesters and some lower priced first-time communities for the millennial generation.

Operator

The next question comes from Buck Horne with Raymond James & Associates.

Buck Horne - Raymond James & Associates, Inc., Research Division - SVP of Equity Research

You mentioned website traffic remains very strong, you had consistent conversion ratios of the buyers coming in. Just curious what your sense of demand elasticity is maybe particularly in California? Can some of the incentives you can offer have a real effect on demand? Or is it more maybe more static than that? And how do you drive more people to actually physically show up at this point?



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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

I'll answer the end first. We drive more people by just being better than anybody else in marketing and having better model homes that everybody talks about and have to go see and having the best website in the business and the best digital marketers and all of the things that I am very, very proud of, and that will continue. We're really good at holding special events that drive lots of traffic and winning lots of awards. Stay tuned, I just heard we're finalists in many, many awards, which is very exciting. With respect to California and the elasticity of demand, it's just too early to tell. I talked about the time of the year. We have not been aggressively chasing buyers with increased incentives. We have significant backlogs that we are working through. And I think again we're going to have to wait and see how the winter spring season develops until we can give you a better answer to that.

Buck Horne - *Raymond James & Associates, Inc., Research Division - SVP of Equity Research*

That's great. And my quick follow-up here is, just on thoughts around community count as we go into 2019. And just, I guess, you alluded it would be to up slightly by year-end 2019, just wondering about the progression. Will it be fairly consistent through the year or near current level? Or will it be kind of a peak and a valley type of situation?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

It will be consistent throughout the year.

Operator

The next question comes from Michael Rehaut with JPMorgan.

Elad Elie Hillman - *JP Morgan Chase & Co, Research Division - Analyst*

This is Elad, on for Mike. My first question, I just wanted to circle back the pace. So pace in California, although it's still above the or at least in the North and the South, it's still above the company average, but maybe not as much above as it has been in the past and just sort of wondering how to think about that maybe on the more normalized basis. Is it better to think of this quarter as sort of a one-off, but pace should continue in California materially above the company average? Or is it better to think of pace in California maybe coming down closer more in line with the company average?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Again, we are not in the business of predicting where the market goes. The pace in 2017, as I mentioned, was north of 10 sales at \$1.5 million and up, which is pretty extraordinary per quarter, that would be 40 sales at that type of price point. And right now, north of 5 is above the company average and a pace that we are happy with, but I will not and cannot predict where that goes. I think if you look at kind of the 2013 to 2016 time frame for California, when California was a good market, but was not certainly as hot as '17. That will give you some indication of past performance for us in that market when things were good.

Elad Elie Hillman - *JP Morgan Chase & Co, Research Division - Analyst*

And then I just want to circle back also to some of the -- I think there was a question earlier, apologize if I missed it. But in the South, we saw a pretty strong order growth there last quarter, I mean, this quarter, it came down and any extra color you could give on what you saw in Florida or Texas, that'll be great?

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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Sure. Dallas had a soft quarter, which is what led that decline.

Elad Elie Hillman - *JP Morgan Chase & Co, Research Division - Analyst*

Same drivers, price appreciation, foreign buyers, interest rates, anything there?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

I am sorry, for Dallas?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I don't think Dallas has a concentration of foreign buyers in the past or currently.

Elad Elie Hillman - *JP Morgan Chase & Co, Research Division - Analyst*

Okay, similar to your latest, like, interest rates and price appreciation. And then lastly I just wanted to ask about the margin profile in that region and if you saw any improvement or contraction in 4Q in any of the regions? Just give some color there?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Sure. I think the margins by region performed pretty much as expected with a few being up, a few being flat, and a few being down, really driven by mix as much as anything else.

Elad Elie Hillman - *JP Morgan Chase & Co, Research Division - Analyst*

[And just] pretty much in last quarter you expected 4 of the 6 regions to improve. So is that the little kind of what you are expecting?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

So we came in a little bit below those expectations, as I mentioned in my introductory comments.

Operator

The next question comes from Matthew Bouley with Barclays.

Matthew Adrien Bouley - *Barclays Bank PLC, Research Division - VP*

On the California segment, I think, Doug you gave the comment that you continue to expect gross margins above the company average in 2019. Is there any finer point you can give on the, I guess, the direction of California margins based on what you have in the backlog today?



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Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I think the California margins have run 400 to 600 basis points above the company average, and I think the best guidance we can give you for '19 for the first quarter is that they'll continue to do so.

Matthew Adrien Bouley - *Barclays Bank PLC, Research Division - VP*

Okay. And then the land and option premiums, you mentioned the \$160,000 average, is there any sense of where you can give or if you can give what that this looks like, I guess, in the more recent orders, any visibility into November, basically the trend there if there's any sense you can give on kind of what actions you may be taking with those premiums to potentially to kind of spur sales?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

It's the same. But to clarify, we're talking about the decorator and structural options that the buyers choose through our process at the sales center in our design studios and then on top of that the individual lot premiums we charge for specific home sites that may have a special value because of views or whatever else they may have. And that number of \$160,000, combining upgrades with lot premium, has not changed.

Operator

The next question comes from Jade Rahmani with KBW.

Ryan John Tomasello - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

This is actually Ryan Tomasello, on for Jade. Just in city living, can you quantify how absorptions have trended in New York City in both your wholly-owned and JV projects in the quarter and perhaps the past few quarters? And how that compares with your expectations?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Sure. I think in New York City, we have relatively low inventory and absorptions have continued to be relatively low. That's not really new, but the New Jersey city living projects we have seen a bit of a slowing consistent with our overall company results. We still really like the gross margin that comes out of this business and the locations.

Ryan John Tomasello - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

And are you able to quantify how the gross margin differential shook out in 2018 versus the broader company average?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

Gregg has that. You want to give the answer.

Gregg L. Ziegler - *Toll Brothers, Inc. - Senior VP & Treasurer*

Sure, city living for the full year ended up in a low 28% versus the company average.



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Ryan John Tomasello - *Keefe, Bruyette, & Woods, Inc., Research Division - Analyst*

And then just overall, how do you view fundamentals and supply in the condo market? Are you seeing an increased use of incentives or price cuts among other projects from other developers? And maybe how long do you think it will take the market to absorb the inventory levels in the market like New York City that seems to be oversupplied at the higher end product levels?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Our experience, as we talked about on prior calls, is that at the higher price point and for the larger units, that drive a higher price point, there is definitely some incentivizing and the market has been softer. We have repositioned our buildings so that we have smaller units that we try to keep it about \$2,000 per square foot selling price and at that end of the market, things are much stronger.

Operator

The next question comes from Alex Barrón with Housing Research Center.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

I was hoping to ask a few questions around the Chinese buyers in California. I was just trying to understand how they compared to, I guess, average buyers? Particularly, when it comes to financing, do they -- are they typically more cash buyers? Or are interest rates actually affecting them? That's, I guess, question #1.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

They are more cash buyers, when they get a mortgage, it tends to be a much lower LTV. I think they are being less impacted by interest rates going up than they are impacted by their ability to invest in the U.S. due to maybe some tightening of or enforcement of some Chinese government policy on foreign investment.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

Got it. Okay. That makes sense. And then another question. Do they typically tend to buy more of the specs that you guys start? Or are they more build-to-order? Or are they just kind of average on that front?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Average.

Alex Barrón - *Housing Research Center, LLC - Founder and Senior Research Analyst*

Okay. And then one for Marty on interest expense. So this year, your interest -- your cost of goods sold was significantly higher than your interest incurred as compared to like 2017. So what can we expect for 2019? Do you think the interest of the cost of goods sold is going to come down more in line with interest incurred?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I think you're going to see for the first quarter of 2019, interest and cost-to-sales to be very consistent with interest and cost-to-sales from 2018.



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Operator

The next question comes from Ken Ling with Citi.

Kenneth Ling - *Citigroup Inc, Research Division - Senior Associate*

Considering the solid SG&A leverage in 2018 and the encouraging projection into first quarter of '19, how much runway do you foresee in improvement particularly in this current operating environment?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

I think we've given you some guidance for the first quarter, and we've explained why we're not giving guidance beyond that and we're going to leave it at that, Ken.

Kenneth Ling - *Citigroup Inc, Research Division - Senior Associate*

Got it. And I guess on a similar note, is there a room to increase in utilization for the TIS, the Toll's Integrated Systems?

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Right now TIS operates from Charlotte up to Boston and up to Detroit and that's the -- that is controlled by transportation and how long it takes to get the panels and trusses from the plant to the job site. And so unless we find more markets within that quarter, I just described, the answer would be no. It's reached its geographic capacity right now.

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

We will find some new plants to operate adjacent to our other markets and that's something that we do look at, but nothing imminent right now.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Correct.

Operator

The last question today comes from Lia Salmansohn with RBC Capital Markets.

Michael Glaser Dahl - *RBC Capital Markets, LLC, Research Division - Analyst*

It is actually Mike Dahl on. A couple of questions. Just wanted to circle back on the absorption side and again not trying to pin you down on a '19 number, but Doug, you made a few comparisons obviously '17 was a really robust year across-the-board and particularly in California. And then you've talked about '16 and you've talked about kind of the period after the taper tantrum as far as things that we can look at as guidepost. But I guess, I'm really trying to understand if you can give us a message around or what that message is around how you're thinking about the business from an absorption level because, I think, 1 year ago the comments were 6 months ago, current mix of business maybe produces 30 to 32 sales something like that, you've finished the year at 28, those prior years quite a bit lower. So any additional color there?



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Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Mike, as I said, I don't have that crystal ball as to where this market takes us. What I will tell you is we have the land, we have the communities opened, we have the teams, we have the brand and we are ready and able to go get more sales and grow this company as we have in the past.

Michael Glaser Dahl - *RBC Capital Markets, LLC, Research Division - Analyst*

Got it. Second question, just clarification. Marty, you made a comment around 4Q gross margins. You didn't get some Brownfield cleanup credits that you expected. Could you quantify that? And just let us know if that's part of...

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

So it was \$5 million to \$6 million. Those credits have been approved by the state in question. They just have yet to be released.

Michael Glaser Dahl - *RBC Capital Markets, LLC, Research Division - Analyst*

Is that part of the 1Q guide?

Martin P. Connor - *Toll Brothers, Inc. - Senior VP & CFO*

It is something we expect to happen in 2019.

Operator

This concludes our question-and-answer session. I would now like to turn the conference back over to Doug Yearley for any closing remarks.

Douglas C. Yearley - *Toll Brothers, Inc. - CEO & Chairman*

Anita, thank you very much. Thanks, everyone. We appreciate all your support and interest, and wish you all a wonderful holiday season.

Operator

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

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