Goosehead Insurance Inc.

The impact of decelerating growth on current and future cash flow generation

Reiterate Rating: UNDERPERFORM | PO: 42.00 USD | Price: 74.98 USD

18 March 2024

Equity

A deeper dive into cash flows; revenues poised to miss

In previous Goosehead notes, we have focused on the inflection from being a company growing its producing staff to one in decline and linking that retrograde trend to the material deceleration in revenue and production trends. While we believe that stock performance generally responds to revenue generation (and we expect the company to miss its 2024 revenue guidance), we also believe investors should decouple "headline" adjusted operating margins from GAAP earnings and underlying cash flow generation.

Three components that overstate earnings/cash flows

A) Share-based compensation, B) non-cash amortization of initial franchise fees and C) the variable/volatile benefit of contingent commissions can serve to cause a mismatch between earnings and free cash flow. We believe that gap appears to be widening as share-based compensation increases, fewer new franchises get formed and contingent commissions fall. Excluding the cash from initial franchise fees, truly free cash flow has been zero over the past 4 years at a time when cash flow nonetheless benefitted from once-in-100-year declines in road collisions during the 2020-2021 pandemic period.

Core earnings/cash flows did improve in 2023

Despite our concerns around earnings/cash flow, the company did generate $8 million in income from core operations and $7 million in truly free cash flows in 2023, up from negative in prior years. Further we expect core margins to be better in 2024 than in 2023. However, this improvement is coming at the expense of a significant deceleration in the company's growth rate, a sharp decline in new franchise appointments and a drop in investment for the future. We believe the relationship between growth and margins to be inverse of one another and is currently playing out in the company's financials.

Decreasing EPS estimates; PO remains $42

We are lowering our EPS forecast, by removing the assumption that the decline in franchises would lead to a decline in non-producing employees. We are increasing our salary/benefit forecast. Our PO of $42 is based upon a discounted-cash-flow analysis using our earnings projections for a 15-20% revenue CAGR through 2028 and a residual growth rate of 10%. With the company guiding to about 20% revenue growth for 2024 against the backdrop of historically high increases in personal lines insurance pricing, we believe the risk is to the downside regarding our longer-term revenue projections. With significant downside potential to our price objective, we rate shares as Underperform.

Estimates (Dec) (US$)	2022A	2023A	2024E	2025E	2026E
EPS	0.55	1.23	1.57	2.24	2.30
GAAP EPS	0.03	0.58	0.83	1.44	1.45
EPS Change (YoY)	14.6%	123.6%	27.6%	42.7%	2.7%
Consensus EPS (Bloomberg)			1.59	2.23	3.20
DPS	0	0	0	1.30	2.58
Valuation (Dec)					
P/E	134.2x	60.0x	47.0x	32.9x	32.1x
GAAP P/E	2,459.7x	127.2x	88.9x	51.2x	50.9x
Dividend Yield	0%	0%	0%	1.8%	3.5%

Key Changes

(US$)	Previous	Current
2024E EPS	1.67	1.57
2025E EPS	2.46	2.24
2026E EPS	2.46	2.30

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Stock Data

Price	74.98 USD
Price Objective	42.00 USD
Date Established	22-Feb-2024
Investment Opinion	C-3-9
52-Week Range	46.77 USD - 92.76 USD
Mrkt Val (mn) / Shares Out (mn)	2,814 USD / 37.5
Free Float	23.4%
Average Daily Value (mn)	22.41 USD
BofA Ticker / Exchange	GSHD / NAS
Bloomberg / Reuters	GSHD US / GSHD.OQ
ROE (2024E)	0%
Net Dbt to Eqty (Dec-2023A)	NA
ESGMeter™	Medium

ESGMeter is not indicative of a company's future stock price performance and is not an investment recommendation or rating. ESGMeter is independent of BofA Global Research's equity investment rating, volatility risk rating, income rating, and price objective for that company. For full details, refer to "BofA ESGMeter Methodology".

Refer to important disclosures on page 18 to 20. Analyst Certification on page 16. Price Objective Basis/Risk on page 16.

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Income Statement Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premiums	188	233	268	286	296
Net Investment Income	NA	NA	NA	NA	NA
Total Revenue	**209**	**261**	**301**	**346**	**363**
Total Cost of Benefits and Claims	NA	NA	NA	NA	NA
S,G & A (Including Commissions)	(186)	(215)	(240)	(250)	(262)
Total Operating Expenses	**(204)**	**(235)**	**(260)**	**(274)**	**(289)**
Pre-Tax Operating Earnings	**5**	**26**	**41**	**73**	**74**
Income Tax Expense	(2)	(3)	(9)	(15)	(16)
Operating Earnings After Tax	**12**	**30**	**44**	**70**	**81**
Net Income (Reported)	**1**	**14**	**23**	**45**	**51**
Diluted Shares	22	24	28	31	35
Operating Earnings Per Share	0.55	1.23	1.57	2.24	2.30
Net Income (Reported) Per Share	0.03	0.58	0.83	1.44	1.45

Balance Sheet Data (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Fixed Income Securities	NA	NA	NA	NA	NA
Total Cash and Investments	29	42	100	184	222
Total Assets	**321**	**355**	**416**	**502**	**541**
Reserves	NA	NA	NA	NA	NA
LT Debt	87	68	68	118	168
Total Liabilities	**355**	**338**	**340**	**390**	**441**
Total Equity	**(34)**	**17**	**76**	**111**	**100**
Total Equity (Ex FAS 115)	**(34)**	**17**	**76**	**111**	**100**
Book Value per Share (Reported)	3/31/2022 120000 AM	3/31/2023 120000 AM	3/31/2024 120000 AM	3/31/2025 120000 AM	3/31/2026 120000 AM
Book Value per Share (Ex FAS 115)	NA	NA	NA	NA	NA

Ratios (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Expense Ratio	98.9%	92.1%	89.7%	87.7%	88.3%
Loss Ratio	0%	0%	0%	0%	0%
Combined Ratio	**98.9%**	**92.1%**	**89.7%**	**87.7%**	**88.3%**
Avg Assets / Avg Eq (Ex FAS 115) Ratio	NM	NM	8.3x	4.9x	4.9x

Growth Rates (YoY) (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Total Earned Premium	41.1%	23.8%	14.9%	6.7%	3.8%
Net Investment Income	NM	NM	NM	NM	NM
Total Revenue	38.4%	24.8%	15.1%	15.2%	4.8%
Operating Earnings per Share	14.6%	123.6%	27.6%	42.7%	2.7%
Asset	20.0%	10.4%	17.1%	20.7%	7.8%
Reported Book Value per Share	0.8%	0.8%	0.8%	0.8%	0.8%

Performance Metrics (Dec)

(US$ Millions)	2022A	2023A	2024E	2025E	2026E
Operating ROE	NA	NA	NA	NA	NA
Operating ROE (Ex FAS 115)	NA	NA	NA	NA	NA
Operating Return on Average Assets	4.1%	8.9%	11.3%	15.3%	15.5%
Operating Margin	5.7%	11.5%	14.5%	20.3%	22.3%
Long Term Debt to Cap Ratio (Ex FAS 115)	163.3%	80.1%	47.0%	51.3%	62.5%
Net Income % Operating Income	4.7%	46.9%	52.8%	64.3%	62.9%
Amtz of DAC % Pretax Profit bef Amtz of DAC	0%	0%	0%	0%	0%

Company Sector

Insurance - Non-Life

Company Description

Goosehead is attempting to build a large-scale personal lines insurance brokerage company using a unique sales and service model. The company operates through its own agents as well as franchise agents. Goosehead leads with homeowners business, which is typically stickier than auto insurance. Customer retention is high in this space and Goosehead keeps a larger percentage of renewal business.

Investment Rationale

Goosehead historically has been a rapidly growing business, but that growth has materially decelerated in recent quarters as its pipeline of potential future franchises appears to be meaningfully curtailed. We estimate 15-20% revenue CAGR over 2025E-27E. That said, we believe that the current share price already reflects the strong growth outlook. At a 11% discount rate on future cash flows, we believe the stock is more than fully valued, risking downside.

Stock Data

Average Daily Volume	298,869

Quarterly Earnings Estimates

	2023	2024
Q1	0.17A	0.29E
Q2	0.41A	0.47E
Q3	0.46A	0.49E
Q4	0.28A	0.32E

We are lowering our EPS forecast for Goosehead. Bullish investors we spoke with observed that our near-term earnings forecast was higher than consensus, which seemed at odds with our Underperform recommendation for the company's shares. This objection generally misses the core of our concerns for the stock, which we will list below. That said, we think the objections to our higher-than-consensus earnings forecast turn out to be well-placed.

> We are lowering our EPS and margin forecast as we now believe we previously were too aggressive in our expectation for employee count decline.

Previously, seeing the decline in franchise count, we modeled a decline in Goosehead's non-producing employee count (those employees that are not customer-facing). Upon further reflection, this seems likely incorrect. As we shall map out later in this note, the growth rate of the non-producing employee footprint does not deviate from the growth rate seasoned franchise count. Scalability seems to have less of an impact that we previously estimated, and we are increasingly skeptical that Goosehead can materially rationalize the employee base to improve its margins. As such we are lowering our EPS as we increase salaries and benefits (due to employee count) where they should have been modeled previously. Our earnings forecast is no longer higher than the Street's, and we expect earnings to enter stagnation or even decline beginning in 2027.

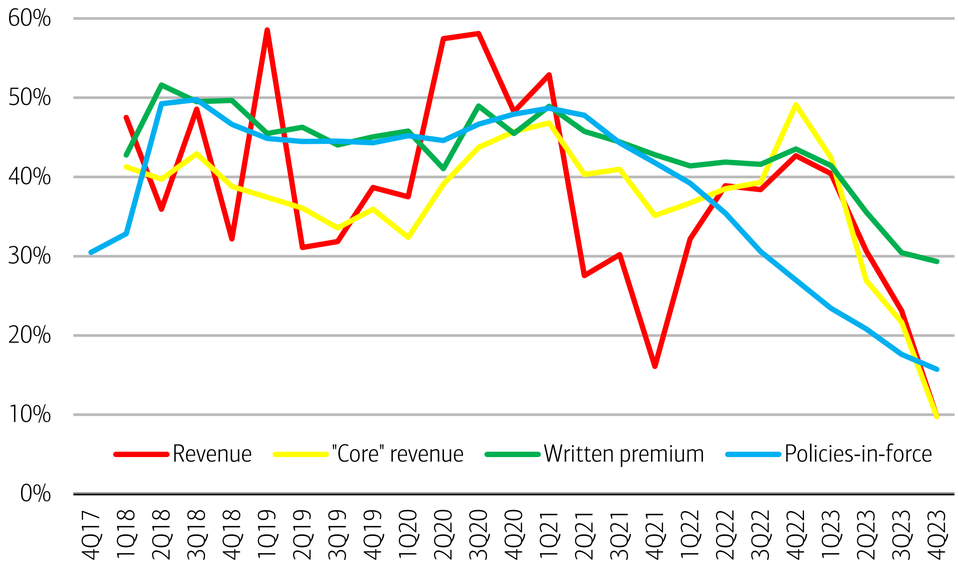
Major areas of concern

That said, we believe there are more urgent concerns for the company, and investors need not look so far into the future, namely:

Decelerating growth. Revenue growth guidance for the company seems too high (and our forecast for $301 million in 2024 revenue falls below management guidance of $310-320 million provided with the company's 4Q23 earnings results on February 21). The company has offered longstanding guidance of 30%+ "controlled"/written premium growth through at least 2027 reiterated as recently as on the company's 3Q23 earnings conference call (October 25, 2023). However, the company failed to deliver said 30%+ growth when it reported 4Q23 results (29.3%) and management 2024 guidance of $3.7-3.85 billion (24.8-29.9%, which we expect will be missed) is also below its long-term target. It is worthwhile to note that this is occurring against the tailwind of the most significant increases in personal lines insurance in almost 50 years. CPI for motor vehicle insurance exited 2023 up 20% year-over-year and has accelerated modestly in 2024 (up 21% year-over-year in both January and February). Further, Texas followed by Florida and California, where Goosehead's footprint is disproportionately large, is experiencing higher inflation that the rest of the USA, indicating that the tailwind is probably even greater in its operational footprint.

Exhibit 1: Year-over year change in Goosehead's top line KPIs

While there are several ways one can mature growth at Goosehead, its growth rate appears to be in meaningful decline in all of them. We believe it worthwhile to note that policies-in-force growth peaked at 48% year-over-year in 2Q21. The other measures sustained their growth rates longer because Goosehead has been benefitting from a once-in-a-generation personal lines pricing tailwind in 2022-present, but, even with that benefit, growth indicators have significantly decelerated (sub-10% revenue growth in 4Q23 on a tough year-over-year comparable).



Source: Company filings

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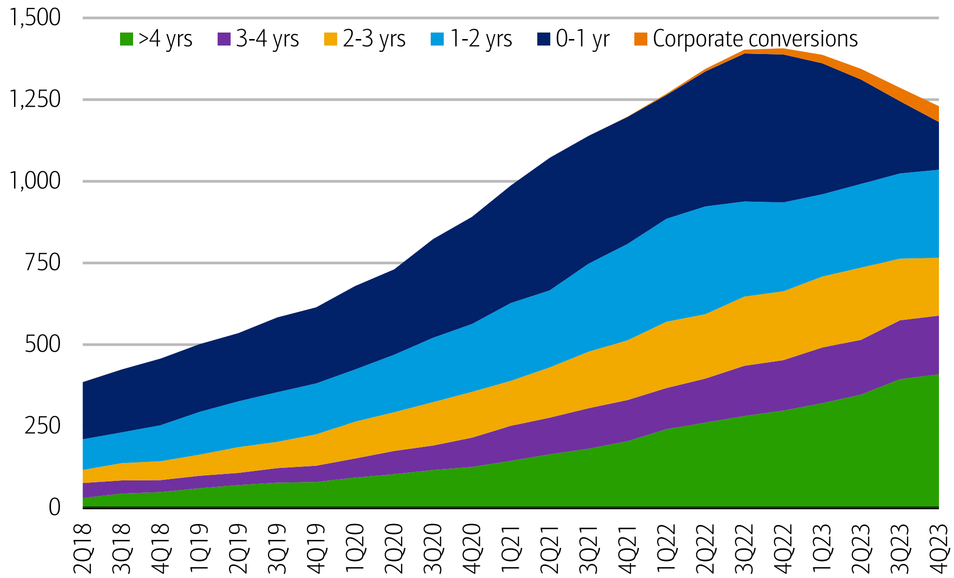
Footprint decline. The growth story at Goosehead has been a function of its franchise model being able to scale up its reach through the appointment of agents nationwide. That growth strategy requires the appointment of new franchises to continue the trajectory. At March 31, 2022, the company boasted a pipeline of 1,030 contracts signed waiting to open new Goosehead agencies. As it turns out, a significant proportion of those contracts were just signatures on a page with no new franchise opened as time passed. The pipeline of signed contracts waiting to open a franchise has declined to 189 at December 31, 2023. The number of onboarded franchises has declined materially from a peak of 285 during 2Q22/3Q22 to the current trough of 54 in 2H23, the lowest since the company began to supply investors with this data (2018). Related, the failure rate of franchises appointed in 2020-2022 has been significant. The pipeline of new franchises matriculating into seasoned franchises has ebbed, and the appointment of new franchisees has sharply declined.

Exhibit 2: Goosehead franchise count by vintage

Goosehead franchises with less than one year experience fell to just 183 as of December 31, 2023 from a peak of 472 a year earlier. We estimate that about 40% of those 472 franchises failed in 2023. If one annualizes the onboarding of just 54 new franchises in 2H23, one should expect franchises with less than one year experience to fall to about 100 by June 30, 2024. This will have a waterfall effect going forward with very few 2023-2024 franchisees likely becoming productive and seasoned producers in the years to come.



Beginning with 1Q23 results, Goosehead management ceased to provide investors franchise data by vintage cohort. The "less than one year" cohort numbers continued to be provided, but the others were not. We have made some estimates to map out the "second year" through "more than four years" cohorts in the graph above during 2023.

Source: Company filings and BofA Global Research estimates

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Poor margins/cash flow conversion. From a low of $20 million in 2021, the company has more than tripled its adjusted EBITDA in just two years. However, the vast majority of that increase has been from non-cash revenues and/or non-core expenses being deducted from the GAAP financials to boost the appearance of profitability. The largest of these items is share-based compensation, which has ballooned to $24 million in 2023 from just $7 million in 2021 and is being "adjusted out" of the headlines numbers. Earnings are also being inflated by the amortization of initial franchise fees that were paid to the company, often years ago, with the associated non-cash revenue only being recognized now. As the company has gained scale, its free cash flow conversion has declined as the pipeline of new, incoming entrepreneurs to pay the initial franchise fees have declined. Over the past four years, excluding the impact of dilutive share-based comp and cash payments from initial franchise fees, strictly-defined free cash flow generation at the company has been cumulatively zero. When one layers on top of that the once-in-a-century benefit of surging 2020-2021 contingent commissions from when there was no traffic on the road during the peak pandemic period, it seems to indicate that normalized cash flow generation at the company is near- or sub-zero.

> The gap between management's "adjusted" headline numbers and underlying free cash flow generation are wide and, we believe, could lead investors to overvalue the stock.

In recent notes, we questioned the decreasing quality of the newer franchisees and detailed how Goosehead's revenue waterfall is deteriorating. In this note, we wish to focus on the cash flow issues. There are many ways that companies can report "earnings." The Financial Account Standards Board (FASB) proscribes the rules for GAAP (generally accepted accounting rules), but that doesn't mean GAAP rules are always correct. Companies and investors alike have come up with a variety of deviations or "adjustments" from GAAP. Sometimes they are useful. We have tended to view some of these as valuable and some as dissimulating. Investors can make up their own minds as to whether these "adjustments" well-explain earnings/cash generation. Generally speaking, we view GAAP net income as typically a conservative measure, while management-"adjusted" numbers could risk painting business operations in the best possible light. In the end, we typically believe true cash returns over the long run should probably be somewhere between GAAP net income and "adjusted earnings."

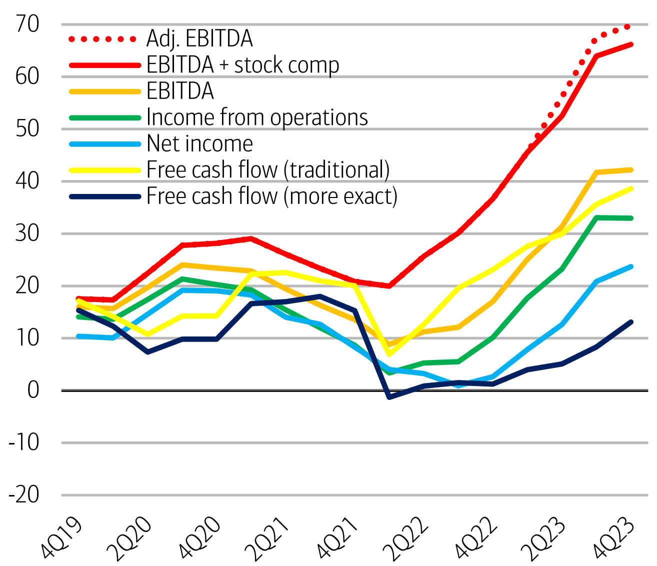
Focusing on cash flow generation

Non-cash compensation: "headline" numbers overstate earnings power

Below we list a variety of ways of presenting earnings/cash generation at Goosehead: EBITDA (earnings before interest, taxes, depreciation and amortization), income from operations (operating revenues less operating expenses), GAAP net income, free cash flow (generally defined as cash flow from operations less capital expenditures) and "strict" free cash flow (we also exclude the benefit of share-based compensation and deferred tax payments from the more traditional free cash flow). We also include Goosehead management's "adjusted EBITDA" numbers:

Exhibit 3: Various measures of "earnings" at Goosehead 2019-2023 ($ in mn)

"Adjusted EBITDA" has more tripled in the past two years, while GAAP net income has fought its way back to where it was in 2020. We would argue that free cash flow (cash flow from operations less capital expenditures and the benefit of share-based compensation and deferred taxes) has struggled between $0-20mn over the past five years with better cash flow generation from 2019-2020 than from 2022-2023.



Source: Company filings

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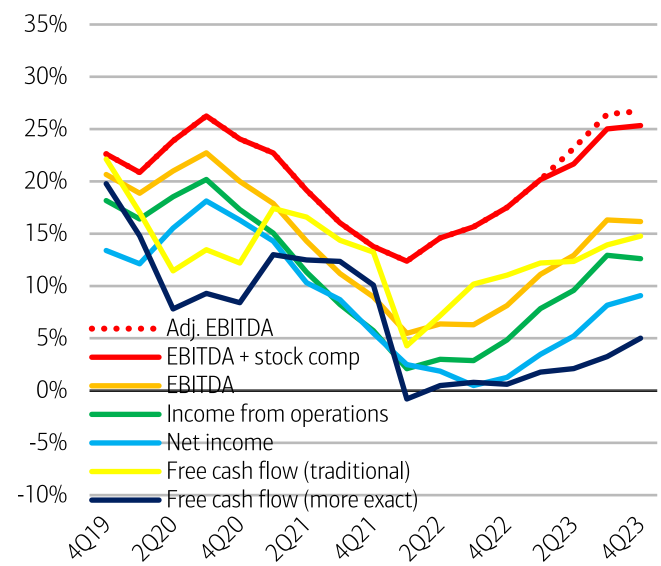
Exhibit 4: Various measures of "margins" as a percentage of revenue at Goosehead 2019-2023

Exhibit 3 fails to convey just how much Goosehead's revenues have grown, and, with that, one could assume that with that substantial growth came some economies of scale benefit. However, this assumption seems incorrect. Generally speaking, and, while not in a straight line, on most measures of margin, the company's earning power has been in decline even as the company has materially increased in size.



Source: Company filings

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In the case of Goosehead, cash flow generally falls below GAAP income. The company is able to report surging "adjusted EBITDA" as it excludes share-based compensation from its definition of earnings, but, on a GAAP net income basis, earnings appear quite weak, and, on our definition of free cash flow (cash flow from operations less capital expenditures and the benefit of share-based compensation and deferred taxes), the numbers appear even lower.

Cash flow generation at the company appears very low after excluding the benefit of share-based compensation from operating cash flows.

Having made this observation in prior reports, some investors have told us that companies often deduct share-based compensation from their adjusted earnings and shareholders, in many cases, have embraced the practice. The argument is that, to view skeptically a company's earnings quality for deducting share-based compensation "double-penalizes" the accounting because it is already captured in the sharecount dilution. While this is true in a single instance, we believe there are three objections to this argument.

- **Recurring dilution.** First, the "double-penalty" argument only logically applies in one-time stock grants. The sharecount at Goosehead appears to rise at about 1.25% annually. To dilute shareholders by 1.25% annually at a cost of about $75/share with $38 million shares outstanding, effectively creates a tax of $30-40 million that shareholders must shoulder annually. If one puts a multiple on year-ahead earnings/cash, it ignores the dilution in perpetuity from recurring stock grants.

- **Insider sales.** Second, management is not holding onto these new stock grants. One might argue that insiders should be paid in stock to increase their alignment with shareholders' goals. However, management/insiders at Goosehead have been selling hundreds of millions of dollars annually, and, whether one argues that share sales are FIFO (first in, first out) or LIFO (last in, first out), the new shares are effectively being sold as quickly as they are received.

- **Software company?** Third, while it may be true that some investors overlook this practice, it does seem confined to software and technology companies or companies that want to be considered software and technology companies. It may be true that Goosehead should be framed in a similar bucket with software and technology companies. That said, earnings disclosure for insurance businesses do not seem to be "adjusting out" their stock comp, and, when it occurs, we believe investors do penalize the company's valuation for "earnings quality" reasons.

Regardless of the stock comp issue, it is unusual to see a maturing company report lower cash flow generation than GAAP income with the gap, if anything, seeming to widen at Goosehead. We believe this deserves more attention.

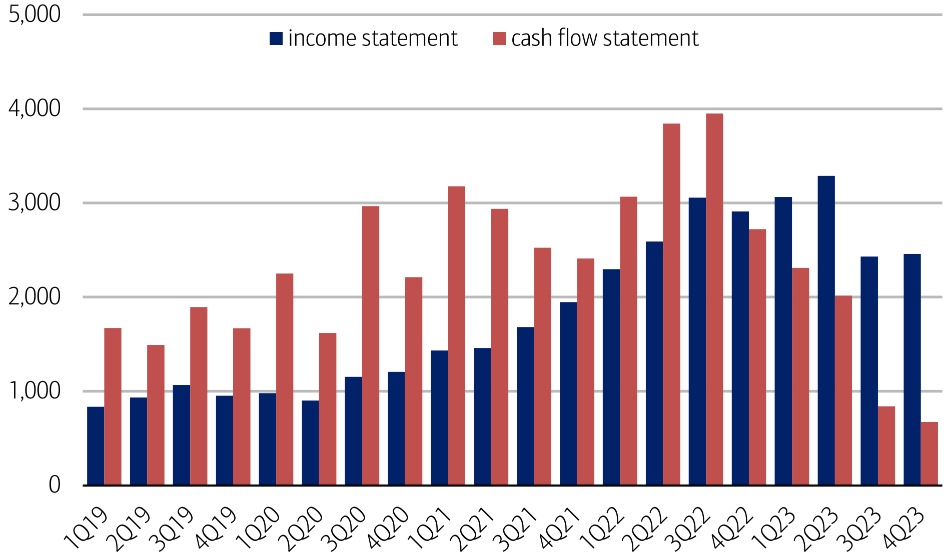
Initial franchise fees: widening gap between cash flow and income

When a new Goosehead franchisee opens a business, Goosehead charges a fee of $25k for a franchise outside of Texas and $40k for a franchise inside Texas. (Some investors we spoke with have argued that Goosehead may be waiving the fees or making no-interest loans to buyers, but management has stated that this is rarely the case.) However, new accounting rules by FASB adopted in 2020 called AS606 require that revenue to be amortized into earnings over 10 years. As such, an entrepreneur who buys a Goosehead franchise today in Texas would pay Goosehead $40k (on the cash flow statement), but Goosehead would only recognize that revenue in increments of $1k over 40 quarters (on the income statement).

There is a widening mismatch between the earnings and cash flows from initial franchise fees.

As Goosehead has slowed its appointments of new franchises considerably, the cash flow from these initial franchise fees—which used to be robust—has dried up, but the income statement continues to enjoy the (non-cash) benefit.

Exhibit 5: Mismatch between cash flows and recognized amortization of initial franchise fees ($ in k)
Because the appointments of new franchisees at Goosehead have declined to very few, a not insignificant portion of quarterly earnings generation is non-cash. From 2019-3Q23 cash from initial franchise fees exceeded the amount recognized on the income statement, but it is now that gap goes the other direction, materially so.



Source: Company filings and BofA Global Research estimates

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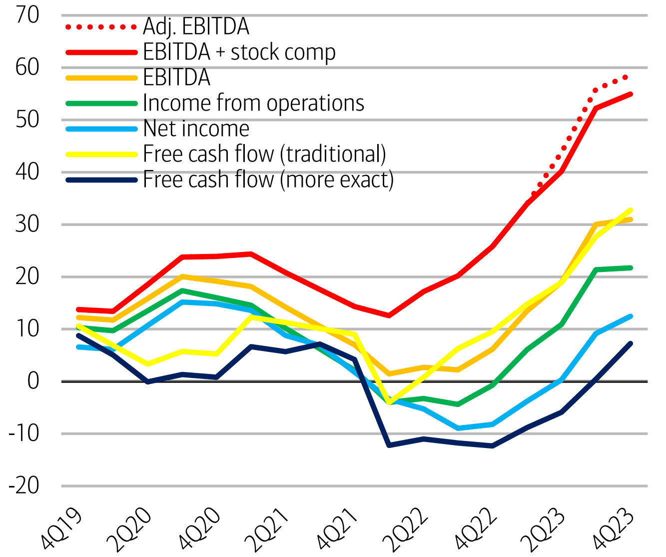
The revenue recognition issues around initial franchise fees have caused sustained strength in a non-cash echo on the revenue side of the income statement for cash received long ago. As a result, it is creating a widening gap where GAAP net income looks better than free cash flow. As we said above, GAAP income isn't always right.

Exhibit 6: Various measures of "earnings" at Goosehead 2019-2023, excluding initial franchise fees ($ in mn)

While "strict" free cash flow seemed about breakeven in 2022-2023, this enjoyed a boost from initial franchise fees, which are received once. Excluding those fees free cash flow might be more accurately described as negative.



Source: Company filings and BofA Global Research estimates

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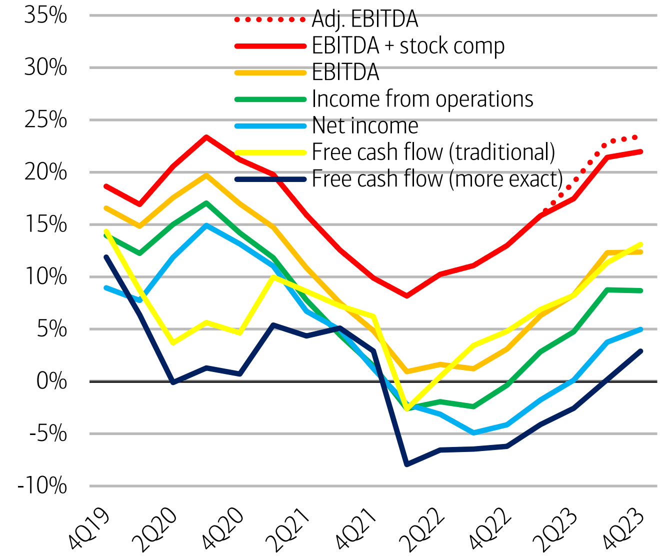
Exhibit 7: Various measures of "margins" as a percentage of revenues at Goosehead 2019-2023, excluding initial franchise fees

While adjusted EBITDA margins have returned to (and even are exceeding 2019 levels), when once excludes initial franchise fees, it would appear that cash flow generation has been effectively zero from the second half of 2019 through year-end 2023.



Source: Company filings and BofA Global Research estimates

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In the charts above, we recast Exhibits 3 and 4 without the benefit of initial franchise fees (we remove it from both revenue and earnings and removed the cash flow component from the cash flow measures). The conclusion is that a tight definition of free cash flow (excluding cap/ex and the benefit of share-based comp and tax deferrals) excluding initial franchise fees has been cumulatively zero over the past four years.

Over the past four years, excluding the impact of dilutive share-based comp and cash payments from initial franchise fees, strictly-defined free cash flow generation at the company has been cumulatively zero.

Now, the initial franchise fees were once real cash, so excluding them entirely may not make complete sense in thinking about valuation. However, we feel very confident that investors should not be putting a multiple on cash received 5 years ago. In 2023, amortization of initial franchise fees exceeded cash generated by initial franchises fees by about $5-6 million. For those who believe that Goosehead shares look attractive at a $2.8 billion market cap—trading at 40x trailing "adjusted" EBITDA or 66x trailing "GAAP" EBITDA or 118x trailing net income—imbedded in that valuation means that the future amortization of cash flows already received in excess of current initial franchise fee cash flow are being valued at $200 million (at 40x trailing "adjusted" EBITDA), $350 million (at 66x trailing "GAAP" EBITDA) and $600 million (at 118x trailing net income).

We estimate there is likely to be an $8-9 million gap between GAAP and cash earnings in 2025 due to initial franchise fee revenue recognition. It may not seem like a lot, but when placed against a valuation multiple of 30x or 50x or 100x, it represents a sizable proportion of Goosehead's market cap.

That's said, these numbers may be underestimating how much the initial franchise fees might be propping up the valuation depending on how tightly one models this line item in the financials. In 2H23, Goosehead onboarding just 54 new franchises capturing about $1.5 million is cash flow if collecting $25k/$40k in cash for initial franchise fees from these 54 entrepreneurs. Meanwhile, the company recognized $4.9 million of revenue associated with initial franchise fees collected in prior periods. However, the $4.9 million was net of $700k in bad debt allowance particularly related to initial franchises amortized in past quarters for which the company never received cash and now understands that no associated cash will be forthcoming. (This relates to the company having already recognized income on many of the peak 1,030 unconsummated contracts at March 31, 2022 from entrepreneurs that did not and perhaps never really intended to open a Goosehead franchise.) If 2H23 is representative of what to expect on the 2024 income statement, investors should expect $11-12 million of non-cash initial franchise fee amortization supported by about $3 million of cash from new franchisees. At 40x, this gap represents $350 million. At 118x, this gap represents $1 billion on a current market capitalization of $2.8 billion.

Employee count: business model struggles to be scalable

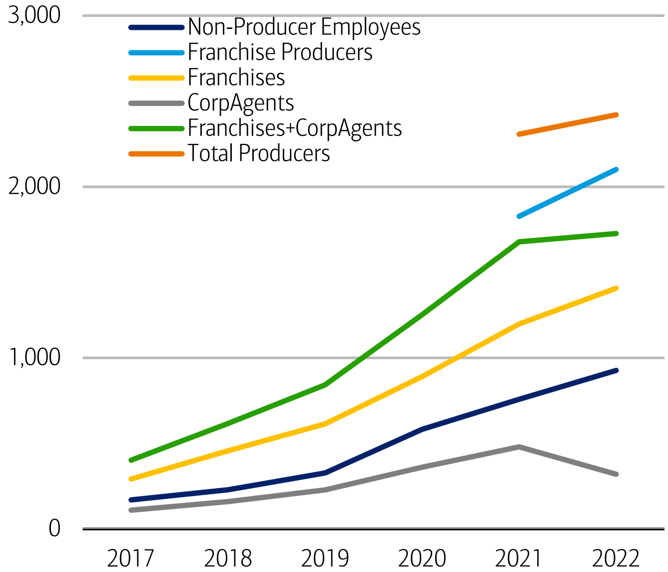
In 2019, Goosehead had an "adjusted" EBITDA margin of around 20% Margins of operating income, net income, cash flow, etc. weren't too dissimilar, and the company ended 2019 with core revenue of $68 million and 614 franchises. Fast forward to 2023, where the company has quadrupled to $233 million in core revenue and doubled franchises to 1,226. With the exception of "adjusted" EBITDA, all other measures of "margin" are lower than they were four years ago (even before deducting the initial franchises fees). This outcome might come as a surprise to some.

> Despite significant increase in its size, Goosehead has not seemed to be able leverage it into better economies of scale.

In theory, Goosehead should be entirely scalable. The franchisees do the customer engagement, and an efficient back office run by Goosehead can behave with centralized leverage. However, in practice, it doesn't seem to have worked that way.

Exhibit 8: Tracking Goosehead employee and producer count

With less than 200 non-producing employees at year-end 2017, this cohort of Goosehead personnel has grown to just short of 1,000 at year-end 2023.



Source: Company filings

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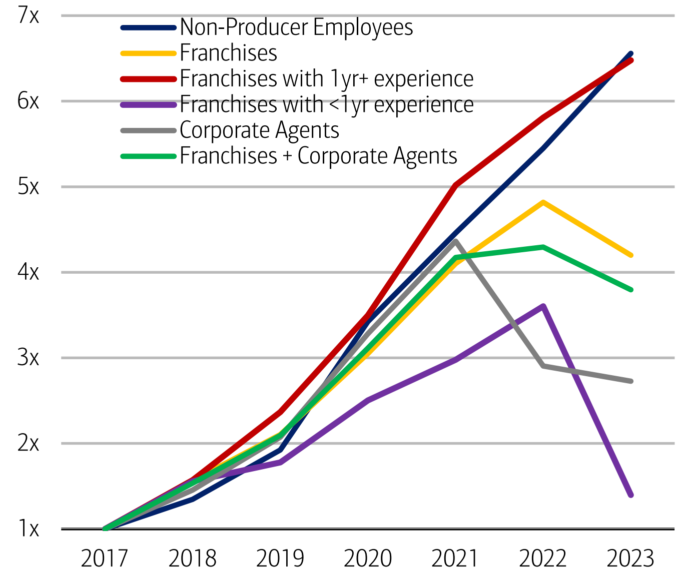
Exhibit 9: Indexing Goosehead employee/producer count to YE2017

Non-producing employees at Goosehead have grown more quickly than another cohort of personnel at the company



Source: Company filings

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At the end of 2019, there were 381 franchises with at least one year of experience. Also, at the end of 2019, there were 327 non-producing employees (555 full-time employees 40 part-time employees and 248 corporate agents). Fast forward to year-end 2023, the number of franchises with at least one year of experience has grown by 170% to 1,043. Meanwhile, the number of non-producing employees has grown 240% to 1,115. Further, the number of first-year franchises, which require more attention and care to get started is actually down 50 (183 at YE2023 vs. 233 at YE2019).

While we would have thought Goosehead's business model more scalable, the company has been adding non-producing personnel even as franchises and corporate agent counts have been in decline.

As mentioned earlier in this note, this relationship had previously caused us to overestimate margins in 2024 and 2025, which we are correcting in this note. We had previously modeled the decline in new onboardings and the assumption of a scalability to lead to declining employee count (also due to the conversion of top producing corporate agents to non-employee franchisees). We also see/saw cutting employees as a lever management can use to improve margins. However, while the investors only get an updated employee count once per year, the YE2023 vs YE2022 trend doesn't seem to imply this. We are now forecasting employee count to remain flattish (even though the longer-term trend suggests it should continue to grow).

Contingent commissions: the one-time boost to 2020-2021 earnings

How insurance agents get paid

In an imaginary world with frictionless transactions and instant price discovery, a customer will always seek out the best price/value offering for the purchase. In insurance, often customers find the purchase too complicated to engage a carrier directly. While we expect the direct-to-consumer marketplace will grow considerably over the next decade (at real risk of disintermediating Goosehead franchisees), at the current time, prospective customers use insurance agents to navigate the marketplace and purchase coverage on their behalf. The agent receives a commission, usually in perpetuity for as long as the policy remains active.

Commission rates vary by carrier and type of business, but it would not be wrong to think of a 12-18% commission range as commonplace. However, a carrier paying a commission rate of 12% will naturally appear less attractive to an insurance agent compared with an insurance carrier paying an 18% commission rate. Technically, an insurance agent is not a fiduciary of the customer. The agent is not required to deliver the best price/value proposition for the customer. Generally, the agent could easily be motivated to seek out a not unreasonable price/value proposition that offers the best commission structure for the agent. The carriers are very much aware that they can sway an agent's decision-making ability by offering more money.

The current system of remuneration in the insurance industry necessarily means agents can be swayed to channel business toward the carrier offering the best commission compensation arrangements.

Further, carriers have an incremental tool to drive the highest quality business in their directions called a contingent commission. This an incremental commission paid to the agent in recognition of business sent to the carrier that produced above-expectation levels of profitability. In addition to procuring the agent's attention by paying a higher initial commission, the carrier can pay the agent an additional kickback if the business delivers higher-than-expectation profitability. This creates a mixed incentive structure. Company A might have the lowest prices/best value because it pays a low commission rate, while company B's price/proposition might be weaker because of the overhead associated with a high initial commission and the potential for incremental kickback. Ultimately, we don't believe these commission structures serve customers well, but it is the system we have today. Agents particularly like contingent commissions, because these bonus commissions are extra and cannot be relied upon, but, when they happen, these revenues tend to fall almost entirely to the bottom line.

Goosehead's experience with contingent commissions

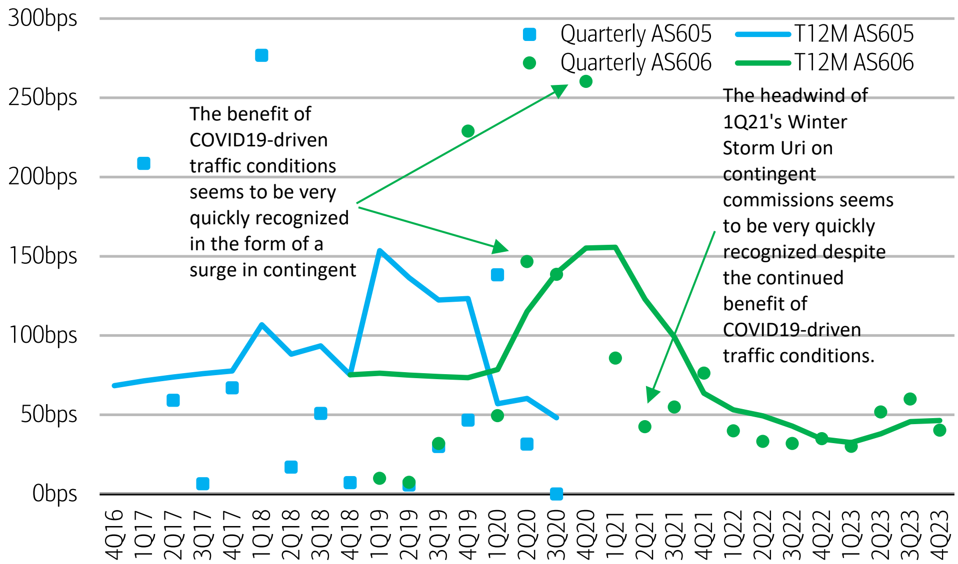
With this in mind, it is useful to note that Goosehead offered what was perceived as soft revenue guidance for 2024. (The stock dropped 18% on February 21 in response.) Frankly, we additionally believe that the soft revenue guidance of $310-320 million is too aggressive and are forecasting $301 million in our model. As part of management's explanation for the soft revenue guidance, management instructed investors to expect weak contingent commissions in 2024 due to poor margins in the U.S. personal auto market. Because auto insurers margins were/are poor, Goosehead and other agents should expect weak contingent commission revenues as margins do not exceed the hurdles required to generate the contingent commission "bonuses." Whereas contingent commissions equaled about 50bps of written premium in 2023 ($14 million in contingents and $3.0 billion of written premium), the company is guiding investors to expect flattish contingent commission 2024 (as described in guidance of a lower 35bps yield on higher $3.7-3.85 billion of premium).

We believe Goosehead may have better-than-guided contingent commission revenues in 2024.

Management may be offering a conservative forecast here. It is true that personal auto insurance margins are poor industrywide, but they have begun to improve, and the trough period for margins was around 2H22-1H23. Further, we expect industry margins to improve by a lot in 2024 as industry written premium exited 2023 with prices up 20% from 2022. Management guidance, which we think aggressive on core revenues, seems too conservative here on the none-core contingents, which have a higher margin. Management explanation suggested that contingents are paid on a lag, and so the 2024 experience should be expected to be worse than 2023 as Goosehead experiences the contingent commissions reflective of trough underwriting margins in arrears.

Exhibit 10: Tracking contingent commissions as a percentage of written premium at Goosehead

While management suggests that the poor margins for personal auto insurance carrier margins will likely bleed into 2024, we would suggest management here is being conservative, and history suggests that any lag on contingent commission earnings is a short one.



Source: Company filings

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However, looking at Goosehead's history, it does not seem that contingents lag carrier profitability much. Contingent commissions surged beginning in 2Q20, reflective of the pandemic causing a huge surge in personal auto underwriting profitability as auto collisions declined to one-in-century temporary lows. Further, it is worth noting a sudden drop in contingent commissions perhaps reflective of the losses associated with Winter Storm Uri in Texas the prior quarter. In fact, contingent commission experience seems to have "stepped up" comparing L9M23 with the 2Q22-1Q23 period, which maps well with carrier underlying margin experience. All in, we suspect there is risk to upside from management's guidance around contingent commissions.

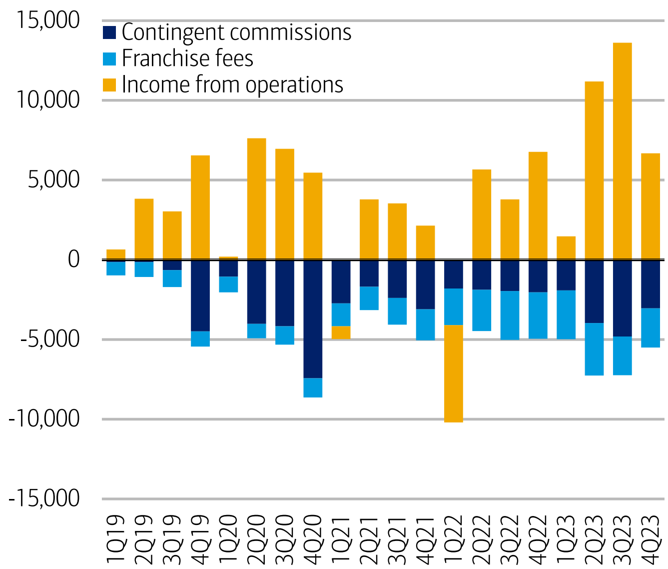
Despite our Underperform rating, we believe there is a risk of a material increase in contingent commissions, particularly in 2025-2025. That said, it probably won't resemble the COVID19 surge, but 2018-2019 (normal, peak-ish carrier margins) might be instructive.

However, there is another reason we digress into a discussion of contingent commissions here, and it relates to the surge in contingent commissions during the pandemic period. We already have pointed out what we view as weak cash flow generation at Goosehead. However, it also should be noted that the cash flow generation at Goosehead (and other agents) enjoyed the contingent commission boost from the once-in-century decline in collisions during the pandemic. This was historical. Further, there was surplus profitability for carriers in 2018/2019 leading into the pandemic as carriers raised prices for auto insurance by 10% annually across 2016-2018, and agents benefitted from that in the form of contingents as well. An argument can be made that 80bps of contingent commissions as proportion of premiums in 2019 was also reflective of "normal" peak market profitability. Past experience with contingents has been elevated. That said, we would expect the industry to also exhibit peak profitability economics in 2H25-1H26, and Goosehead's 2019 experience might be useful in trending to out-year experience.

Contingents + Initial Franchise Fees: poor core earnings generation

That said, like initial franchise fees, one might believe it prudent not to put a high multiple on contingent commissions, given their variability, at least not the same way one might value earnings from core revenues. However, one might note that almost all income from operations at the company has come from either a) initial franchise fee amortization (non-cash) or b) contingent commissions (variable).

Exhibit 11: Relationship between income from operations vs. contingent commission and initial franchise fees (quarterly, $ in ks)
The company defines "core revenues" as royalties and regular commissions plus agency fees (not to be confused with initial franchise fees), but almost none of its earnings have been generated by the core revenues.



Source: Company filings

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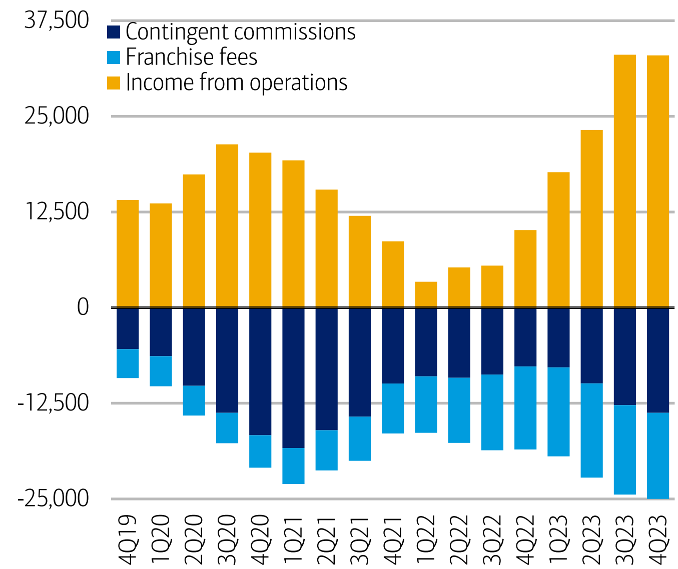
Exhibit 12: Relationship between income from operations vs. contingent commission and initial franchise fees (T12M, $ in ks)
The company defines "core revenues" as royalties and regular commissions plus agency fees (not to be confused with initial franchise fees), but almost none of its earnings have been generated by the core revenues.



Source: Company filings

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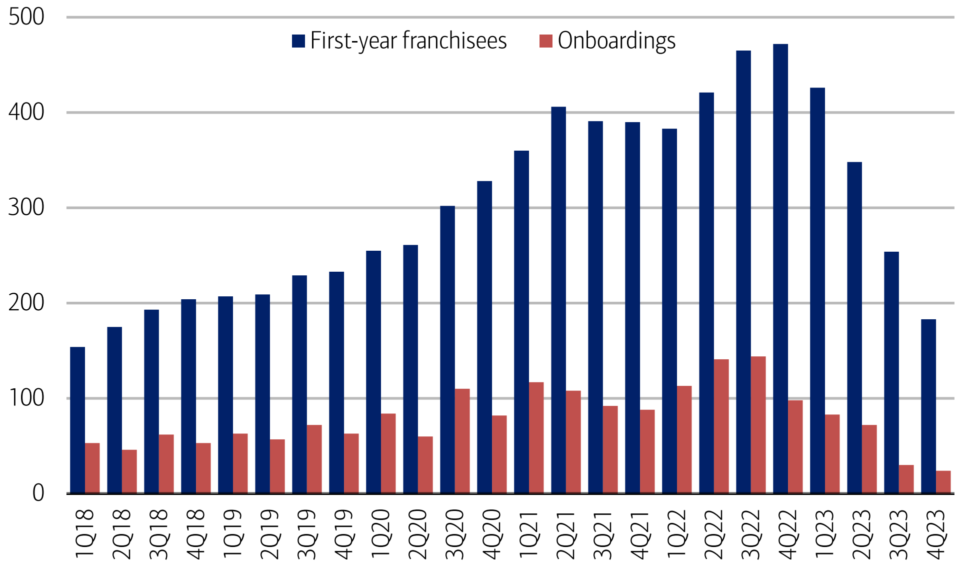
Stripping out initial franchise fees and continent commissions, earnings have been essentially negligible. That is, however, until 2023. Bulls would be correct to point out that the company generated $33 million in income from operations, but only $25 million came from initial franchise fees and contingent commissions. That is $8 million of income from core operations on a base of $236 million in 2023 core revenues. That may be just 3.4% core operating margins, but it is better than -0.7%, -5.8% and -4.4% for 2020-2022, respectively. The past may have been problematic, but, while earnings and cash flow (and their respective margins as a percentage of revenues) are small, they seem to be finally headed in the right direction (see Exhibits 3, 4, 6 or 7). We agree with this interpretation of the numbers. And, bulls will argue, not foolishly, that it is the future on which one should focus, not the past.

Exhibit 13: Goosehead first-year franchisees and onboardings

While earnings and cash flow generation have indeed improved at Goosehead (albeit off a small or even negative base), this has come concurrently with a massive decline in onboarding and franchisee education. Should the company stop adding new points of sale, we believe margins would improve even further, but it would only serve to forestall growth.



Source: Company filings

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The improvement in margins/cash flow does not occur in isolation. Goosehead should have been able to improve margins by cutting expenses, particularly in the back half of 2023. We would note that the improvement in cash flow/earnings generation comes concurrently with other trends, most notably the significant decline in onboarding new franchisees and the related decline in the presence of the most junior producers most in need of the home office's help. The margin improvements come as franchises decline and the number of corporate agents falls. We would argue that the company is saving money by not training/educating new producers and not having to service the needs of the more junior producers.

Margins have indeed improved (off as small or negative based), but the company's investment in future growth has been radically reduced

There is a cost to these margin improvements: production is materially decelerating (Exhibit 1) and the investment in the future has been radically cut (Exhibit 13). We do not argue that it is not possible for Goosehead to be cash flow positive, nor do we argue that there isn't a cash value of hundreds of millions of dollars in the back book of policies already underwritten waiting to be earned/received. Rather, we argue that such earnings/cash flow comes is a function of earning in the present at the expense of growth into the future. We expect that the company will produce more free cash flow in 2024 vs. 2023. However, we also argue that new franchises formation and revenue growth overall seems poised to further disappoint.

Price objective basis & risk

Goosehead Insurance Inc. (GSHD)

Our $42 price objective is based on discounted-cash-flow analysis using our earnings projections for a 15-20% revenue CAGR through 2028 and a residual growth rate of 10%. The 10% residual growth rate runs ahead of mature large-cap brokers, but smaller outfits have tended to grow more quickly. We select an 12% discount rate to reflect the surge in interest rates beginning last in 2021.

Downside risks are disintermediation of the agency sales model to captives and direct channels as well as declining interest from potential franchisees. Upside risks are acceleration in franchise growth and increased pace of homeownership.

Analyst Certification

I, Joshua Shanker, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

US - Insurance Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Aflac	AFL	AFL US	Joshua Shanker
	Allstate Corp.	ALL	ALL US	Joshua Shanker
	Arch Capital	ACGL	ACGL US	Joshua Shanker
	Assurant	AIZ	AIZ US	Grace Carter, CFA
	Axis Capital	AXS	AXS US	Joshua Shanker
	BRP Group, Inc.	BRP	BRP US	Joshua Shanker
	Cincinnati Financial Corporation	CINF	CINF US	Grace Carter, CFA
	Corebridge Financial	CRBG	CRBG US	Joshua Shanker
	Everest Group Ltd	EG	EG US	Joshua Shanker
	Intact Financial	YIFC	IFC CN	Grace Carter, CFA
	Intact Financial	IFCZF	IFCZF US	Grace Carter, CFA
	MetLife	MET	MET US	Joshua Shanker
	Progressive	PGR	PGR US	Joshua Shanker
	RenaissanceRe	RNR	RNR US	Joshua Shanker
	The Hartford	HIG	HIG US	Joshua Shanker
	Voya	VOYA	VOYA US	Joshua Shanker
	W.R. Berkley	WRB	WRB US	Joshua Shanker
NEUTRAL				
	American International Group	AIG	AIG US	Joshua Shanker
	Aon	AON	AON US	Joshua Shanker
	Lincoln National	LNC	LNC US	Joshua Shanker
	Marsh McLennan	MMC	MMC US	Joshua Shanker
	Principal Financial Group	PFG	PFG US	Joshua Shanker
	Prudential Financial	PRU	PRU US	Joshua Shanker
	The Hanover	THG	THG US	Grace Carter, CFA
	Trupanion	TRUP	TRUP US	Joshua Shanker
	Unum	UNM	UNM US	Joshua Shanker
UNDERPERFORM				
	Arthur J. Gallagher & Co.	AJG	AJG US	Joshua Shanker
	Brown & Brown	BRO	BRO US	Grace Carter, CFA
	Chubb Ltd	CB	CB US	Joshua Shanker
	CNA Financial	CNA	CNA US	Joshua Shanker
	Goosehead Insurance Inc.	GSHD	GSHD US	Joshua Shanker
	Selective	SIGI	SIGI US	Grace Carter, CFA
	Travelers Cos	TRV	TRV US	Joshua Shanker
	Willis Towers Watson	WTW	WTW US	Joshua Shanker

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Business Performance	Numerator	Denominator
Return On Capital Employed	NOPAT = (EBIT + Interest Income) × (1 – Tax Rate) + Goodwill Amortization	Total Assets – Current Liabilities + ST Debt + Accumulated Goodwill Amortization
Return On Equity	Net Income	Shareholders' Equity
Operating Margin	Operating Profit	Sales
Earnings Growth	Expected 5 Year CAGR From Latest Actual	N/A
Free Cash Flow	Cash Flow From Operations – Total Capex	N/A
Quality of Earnings	**Numerator**	**Denominator**
Cash Realization Ratio	Cash Flow From Operations	Net Income
Asset Replacement Ratio	Capex	Depreciation
Tax Rate	Tax Charge	Pre-Tax Income
Net Debt-To-Equity Ratio	Net Debt = Total Debt – Cash & Equivalents	Total Equity
Interest Cover	EBIT	Interest Expense
Valuation Toolkit	**Numerator**	**Denominator**
Price / Earnings Ratio	Current Share Price	Diluted Earnings Per Share (Basis As Specified)
Price / Book Value	Current Share Price	Shareholders' Equity / Current Basic Shares
Dividend Yield	Annualised Declared Cash Dividend	Current Share Price
Free Cash Flow Yield	Cash Flow From Operations – Total Capex	Market Cap = Current Share Price × Current Basic Shares
Enterprise Value / Sales	EV = Current Share Price × Current Shares + Minority Equity + Net Debt + Other LT Liabilities	Sales
EV / EBITDA	Enterprise Value	Basic EBIT + Depreciation + Amortization

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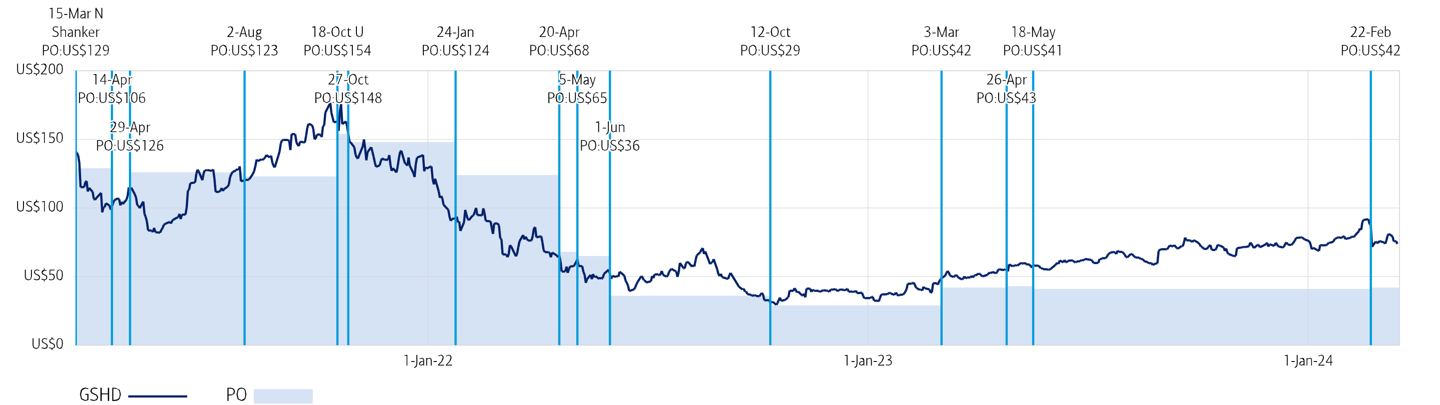
Disclosures

Important Disclosures

Goosehead (GSHD) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Equity Investment Rating Distribution: Financial Services Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	156	53.79%	Buy	94	60.26%
Hold	72	24.83%	Hold	48	66.67%
Sell	62	21.38%	Sell	35	56.45%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships [R1]	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster[R2]
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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