Report Date: February 16, 2023
Company: Goosehead Insurance, Inc.
Ticker: GSHD US
Industry: Insurance Brokerage
Stock Price (USD): $42.57
Market Cap (USD, Millions): $1,589.9

GSHD: A Growth Story In Decline And Priced To Fall

We are short Goosehead Insurance (Nasdaq: GSHD) for three key reasons: (1) our analysis shows that, contrary to management's claims, the failure rate of their first-year franchisees topped 67%[1i] in 2021 and we expect that number to increase again in 2022; (2) GSHD's reliance on the housing market is much greater than management lets on – former employees told us that 85%-95% of their new business relies on referrals from people in and around real estate; and (3) we calculate that the CEO and other pre-IPO investors have taken more than $900 million[2] off the table while the company has only generated $23.4 million in cumulative net income since the IPO, contradicting management's purported belief that GSHD's growth is only getting started.

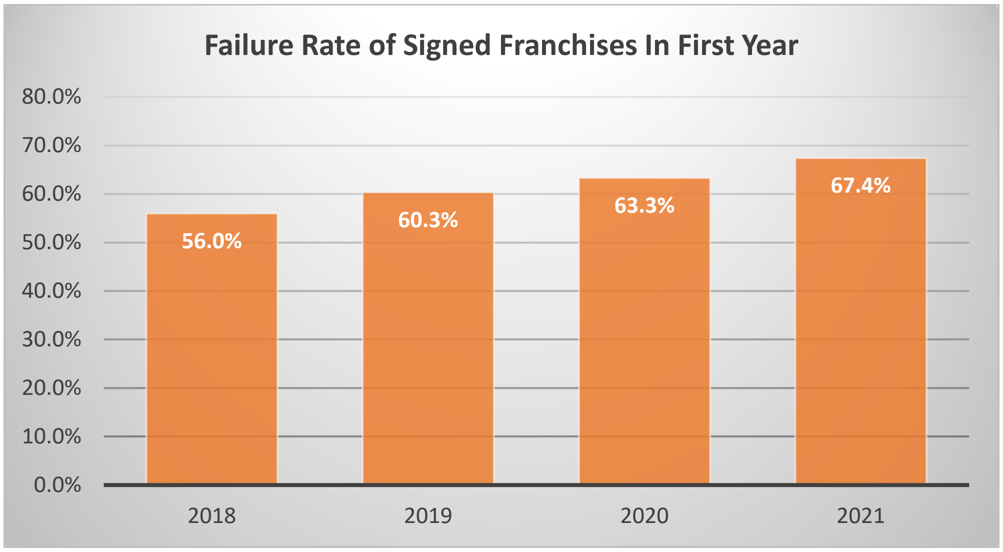
Franchisees primarily fail because they make very little money and are cannibalized by the company's corporate channel. We calculate that the median first-year franchisee brings home just $38,400,[3] and that does not include payments on the debt that most franchisees take on to finance their fee. As of Q3 2022, 700[4] of GSHD's 1,403[5] operating franchisees have less than two years of tenure and are at risk of failing because their leads are drying up and they don't have a large book of renewals to fall back on. Franchisees that shutter, like the 193 that have already closed this year by our count, [6] risk losing their homes since the spouse of the franchisee must also sign a personal guarantee as part of the franchise agreement.

Contrary to management's recent representations concerning their dependence on the housing market, our interviews with former employees indicate that GSHD counts on leads for homeowners' insurance to cross sell other personal lines of insurance. As interest rates have risen, the demand for mortgages has fallen 67% YoY, and existing home sales have fallen 35% YoY.[7] Our analysis of GSHD's data shows their growth is suffering, with GSHD's growth in the number of policies in force hitting its lowest point in Q3 since the IPO, [8] we expect this carnage to worsen in Q4 since that is usually the slowest time of the year in the housing market.

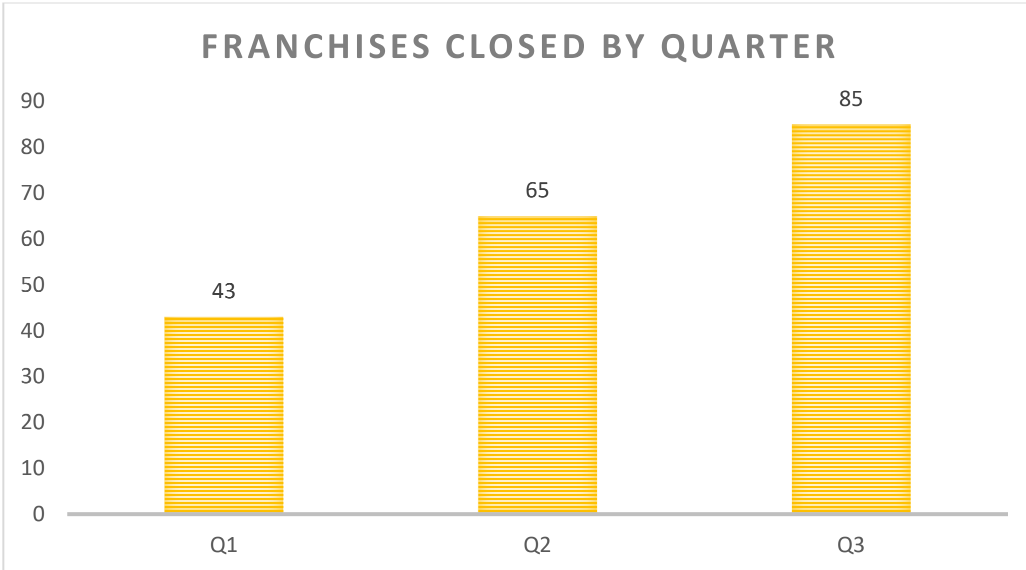
GSHD's governance bears a closer resemblance to a fiefdom than a corporation. Mark Jones is the CEO and Chairman, his wife is the Vice-Chairman, his son is the CFO, and his son-in-law is the Chief Legal Officer. GSHD has a Stockholders Agreement that, in our view, makes the board impotent to stop the CEO from filling his pockets at the expense of shareholders. The board must seek permission from Mark Jones before taking any substantial actions against him or other key C-Suite members in his family.[9] This arrangement is the subject of a recent class action lawsuit filed by a current franchisee[10] and shareholder alleging it flouts Delaware law concerning corporate governance.[11]

[i] (Double click on Endnotes to view source)

Signing a GSHD Franchise Agreement Comes with a High Risk of Failure



- According to our calculations, as discussed in Appendix A, since GSHD went public in 2018, the failure rate for signed first-year franchisees has increased from 56% to 67.4%.
- Management is spinning an increase in churn as a positive. [12] It is not. In our view, increased churn can only mean that more franchisees are running out of money and defaulting on their agreements.[13]
- In our assessment, the real reason GSHD is warning analysts that churn will increase is because the company's growth is rapidly declining because of the conditions in the housing market where applications for mortgages have declined 67% YoY:
  - GSHD's has touted its narrow focus on building relationships with referral partners tied to home closing transactions, like real estate agents and loan officers, as their differentiating business strategy. This strategy may have fueled growth for GSHD when the housing market was active, but our analysis indicates that it is becoming a serious drag on the company's growth as the housing market has slowed.
  - We spoke with five former employees and one point of agreement was that nearly all referrals, (85%-95% according to former employees who put a number on it), were tied directly to home closing transactions. The agents would then try to cross-sell leads on other types of insurance to go along with their homeowner's policy. These leads have dried up significantly as a slowing housing market has driven down demand for mortgages nationwide and the cross selling that goes with it.
  - Rising premiums have driven up the company's renewal revenues, but renewals have previously only accounted for 60% of revenues.[14] 700 of GSHD's 1403 franchisees have less than two-years of tenure.[15] New franchisees need to write *new* policies to stay in business and 193 franchisees have already closed their doors in 2022.[16]



- Franchisees fail because they tend to make extraordinarily little money as they get started, even in the good times. Our analysis, based on GSHD's franchise disclosure document (FDD), indicates the median Gross Commissions of a franchisee with a full year of tenure was just ~$48,000, and that only 36% of franchisees earned this amount or more. [17] Our analysis indicates that the median franchisee with a full year of tenure earned net commissions of just $38,400, due to a 20% fee that franchisees pay on all new business. These metrics were derived from years when the housing market was strong, and we expect these numbers will be worse in 2022.
- Approximately 36% of franchisees reside in states where they are cannibalized by GSHD's corporate channel[18] which competes for referral partners. Having started in Texas, the corporate channel has expanded to Ohio, Illinois, Colorado, and North Carolina. The CEO stated that the company's corporate channel is a break-even business, [19] making the expansion of the corporate channel a serious unforced error. In contrast, GSHD's competitor, Brightway Insurance, does not have a significant corporate channel.

- Franchisees that choose to finance their franchise fee and then fall into delinquency may be as bad off as people who took out a payday loan and never got a payday. Interest accrues at 1.5%[20] a month, and a franchisee can even lose their home, as GSHD requires the spouse to also sign a personal guarantee:

> "**Spousal Liability**. *Your spouse must sign a document that makes your spouse liable for all financial obligations under the franchise agreement even though your spouse has no ownership interest ... This guarantee will place both your and your spouse's marital and personal assets, perhaps including your house, at risk if your franchise fails."*[21]

GSHD's Corporate Structure Allows Management to Enrich Themselves at the Expense of Shareholders

- GSHD is run by one family, and they have been able to retain an iron grip on the company, despite going public, through GSHD's convoluted corporate structure.[22] GSHD is a holding company that currently owns 56.7%[23] of the underlying business, with the rest held by Mark Jones and other pre-IPO holders. The interests of the pre-IPO members are represented by Class B shares, of which 89%[24] are held by Mark Jones.
- Since its IPO, GSHD has paid $117 million in dividends and ~$60 million went directly to the holders of GSHD's Class B shares because of the company's corporate structure. To be clear, GSHD's shareholders took on debt, held by the company, and more than half of the proceeds went into the pockets of the CEO and the other pre-IPO holders.
- A Tax Receivable Agreement (TRA) also entitles the CEO and other Class B stockholders to 85% of all the tax benefits that flow to GSHD when these shareholders increase GSHD's tax basis by trading in their shares of the underlying business for shares in the holding company. As of Q3 2022, GSHD owed the CEO and the other pre-IPO members $112.4 million under the TRA. At this rate, the CEO and other members could garner an additional $280 million[25] just by swapping their Class B shares for Class A shares.
- The board is essentially powerless to reign in C-Suite because the Stockholders Agreement prevents them from removing key members without authorization by the majority holders of the Class B shares, [26] which are Mark Jones, the CEO and Chairman of the Board, and his wife Robyn, the Vice Chairman of the Board, who beneficially own 89%.[27] This allows them to shield members of the C-Suite, like their son, Mark Jones Jr., the CFO, and their son-in-law, P. Ryan Langston, who is GSHD's VP and Chief Legal Officer.

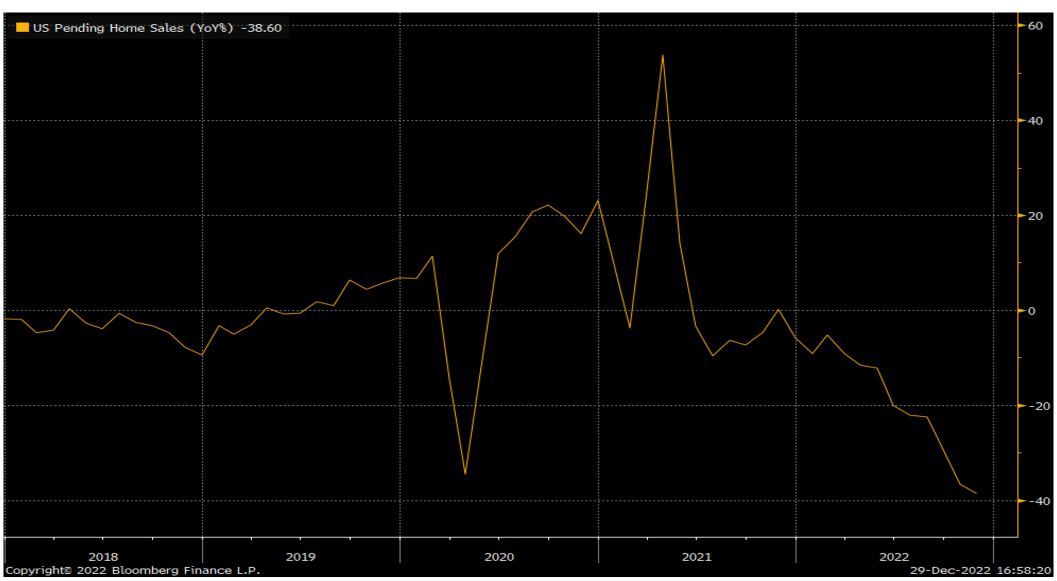
GSHD's Growth Story Is Deteriorating Because the Slowing Housing Market Is Drying Up Referrals and Driving Franchisees Out of Business

GSHD's secret sauce is real estate referral partners. Every former employee we spoke to about the company's business model stressed that the company's strategy was to build relationships and get leads from referral partners for new home insurance policies. After receiving a lead from a referral partner like a real estate agent or a loan officer, the GSHD agent would try to cross sell other types of personal insurance, but almost all GSHD's business would flow from an initial need for homeowner's insurance.

With the three former employees we asked about the referral program, it was a point of universal agreement that most referrals, 85-95%, were reliant on home sales. One former Account Executive made this point succinctly:[28]

> ***Interviewer:***
>
> *How much of your business … comes from referrals?*
>
> ***Account Executive:***
>
> *… I would say, realistically, 95% of my leads came from the relationships I built:*
>
> ***Interviewer:***
>
> *… How much of that was from the housing market?*
>
> ***Account Executive:***
>
> *It is all based on housing.*

This reliance on referral tied to home sales is a problem for GSHD because demand for mortgages has fallen off a cliff, declining by 67% YoY. Pending home sales have fallen by 38% YoY, falling below the level reached at the height of the Covid-19 panic:



As a practical matter, this means that GSHD's existing referral partners are generating fewer leads.

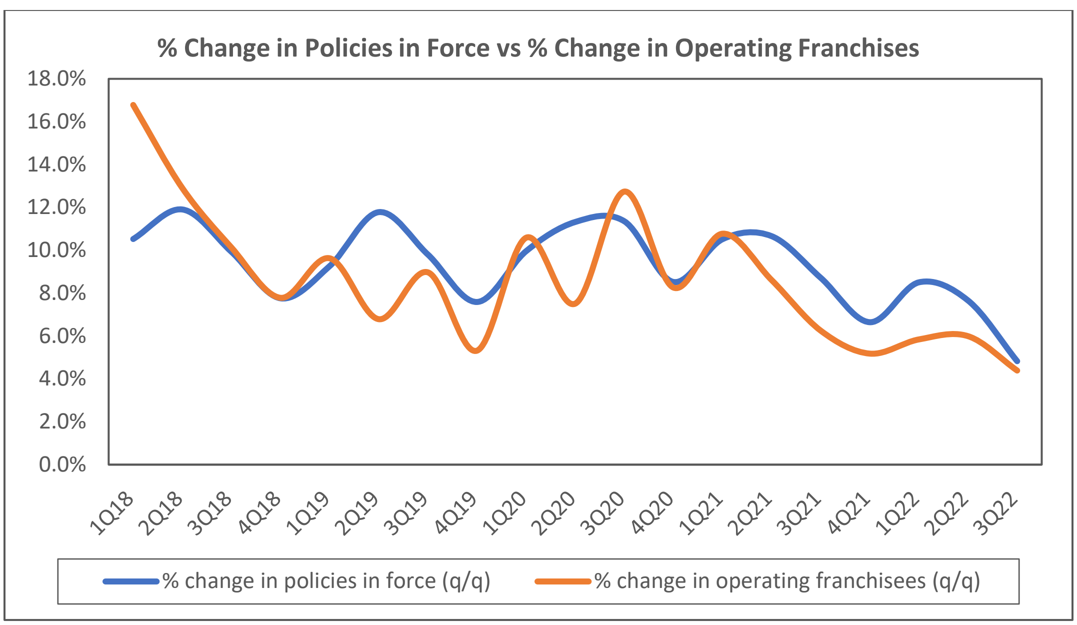
Another point of agreement amongst all the former employees we spoke to about the housing market was that a slowdown posed a significant obstacle for GSHD. A former Account Executive, who left in September 2022, provided us with some specifics on how referrals were drying up:

> *On the front end [of my tenure], it was still favorable rates, and it was a really favorable housing market, and 8 months in,* ***I saw a really big decrease in that, some of my best partners, there were probably two, sending me 5-10 leads a month, and there were a couple months where, it was like, maybe one****.*
>
> *And it was like, what the heck was happening, that was* ***one thing that really worried me … is how am I going to continue to build my book of business if people are no longer buying houses?***

GSHD's management has attempted to downplay the effect of the housing market on its business by claiming that a mere 20% of its business has exposure to the housing market.[29] However, we think that management is fudging this number by omission because the company's agents rely on initial leads from home sales to cross-sell other types of personal insurance.

In the prior earnings calls, management has stated that 60% of the company's revenues came from renewals,[30] indicating that most of the remaining 40% comes from new growth, and it is our assessment that almost all this new growth has been dependent on the housing market. As home closings slow, so will cross-sales for auto and other types of insurance, hitting the brakes hard on the company's growth.

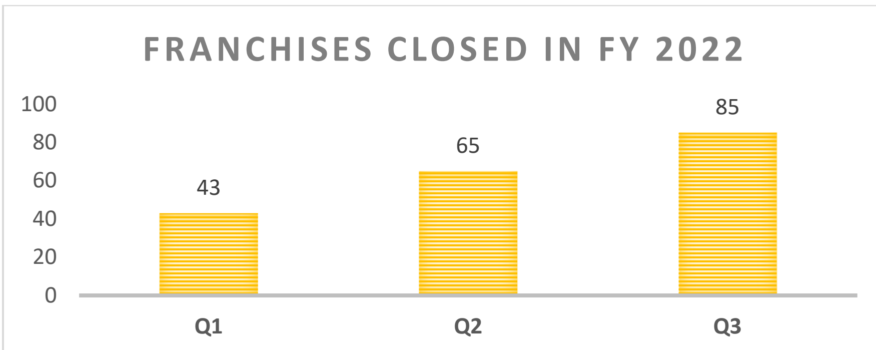
The slowdown in the housing market has already had a significant effect on growth. The growth in the number of policies in force for the company has fallen this year below any level recorded since the company's IPO in 2018.



This deceleration also correlates with a deceleration in the growth rate of operating franchisees. The company's cyclical growth typically hits a nadir in Q4 since that is when the housing market is typically at its weakest. This year has seen uncharacteristically low growth across the board, so we expect the company's growth rate to hit new lows in Q4.

GSHD's agents do not have a magic wand it can wave here; the only solution is to go out and solicit more referral partners or mine their existing contracts for additional policies.[31] Soliciting more referral partners is not easy, it is illegal for referral partners to receive a kick-back of any sort, so the franchisees need to get a win by developing a personal relationship with them. These referral partners will often have another local insurance broker whom they typically use.

Our calculations indicate that 193 franchisees have already closed their doors[32] through Q3 this year, a testament to how difficult it is for franchisees to win new referral partners when times are tough.



As of Q3 2022, GSHD had 700 franchisees who have less than two-years of tenure and many of them will be hard pressed to stay open. In Q3, the CFO stated that operating franchisees have been failing this year at much higher rates than would be typical, 25% annualized in Q3, and the CFO stated that he expected the churn rate to increase even higher in the near term.[33]

We take these comments as a signal that the company's internal metrics indicate that franchisees are going to churn at an even faster rate in Q4 than they did in Q3. We would not be surprised if the number of franchisees that shuttered exceeded the number of franchisees that opened in Q4 for the first time since GSHD's IPO.

GSHD's management has taken the position that it is culling unproductive franchises so it can better allocate resources, which is really the only spin they can put on such bad news. GSHD cannot terminate franchisees at will the same way it can fire employees.[34] Termination typically occurs when a franchisee repeatedly defaults on payments or violates a covenant.

These franchisees are the engine of GSHD's growth, and the cuts they are experiencing now will have a significant impact on the company's growth rate for a significant amount of time.

There are also no signs that the housing market will rebound significantly in 2023 as the fed continues to raise interest rates and recession looms on the horizon.

Franchisees Fail Because They Make Very Little Money While Taking on Significant Debt from GSHD

According to our calculations, the rate of signed franchisees in their first year that have failed to successfully get to their second year has been increasing since the IPO, eclipsing 67% in 2021.[35] The primary reason so many franchisees are failing, in our opinion, is because they are not making enough to pay their bills. According to the FDD, the median Gross Revenue for franchisees after their first year was ~$48,000, and that does not include a 20% royalty that GSHD collects on new premiums, meaning that the median GSHD franchisee made just $38,400 from their business in the first year of their tenure. For franchisees that financed their fee, they also paid $6,000-10,000 (depending on their state) in their first year for their debt. [36]

It is our understanding from our conversations with former employees that most franchisees finance their fees. One former employee told us 65% of franchisees financed their fees, but a franchise recruiter indicated that the number was closer to 95%. The former franchise recruiter also stated that some franchisees put their entire life's savings into starting a franchise.

According to the former franchise recruiter, there was a lot of pressure from the company to meet quarterly numbers, even if that meant selling to people who were likely to fail.

GSHD's Corporate Channel is Cannibalizing Its Franchisees

The slow-down in the housing market is not the only flaw in GSHD's growth narrative. As franchises proliferate, they start competing for the same referral partners. This competition amongst franchisees makes it more difficult for newer franchisees to get established, helping to drive the failure rate of new franchisees even higher.

On top of competition with other franchisees, many also must compete with the corporate channel. According to GSHD's FDD document, 36% of the company's franchisees are in a state where the corporate channel has a presence.[37] The corporate channel started in Texas, but it has expanded into Illinois, Colorado, North Carolina, and Ohio, where it will eat into business opportunities for franchisees.

For example, in Texas, which is the company's most mature market, the cannibalism of new franchisees due to market saturation is particularly pervasive.[38]

In Texas from 2019-2021, 124 new outlets opened, and 55 were terminated or closed,[39]. The overall rate for GSHD in the same period was substantially better, with 1,003 outlets opened and 262 terminated or closed (this does not include franchisees who failed to launch as discussed in Appendix A).

When we asked a former franchise recruiter about how the company talked about the cannibalization problem with prospective franchisees in Texas, the former employee indicated that they were taught to deflect prospective franchisees concerns as to how the saturation problem would affect their chances:

> ***Franchise Recruiter:*** *A lot of the [prospects] would always have that concern, "Don't you have an entire team focused on the DSW-Texas Area?"*
>
> ***And what we were trained to say*** *is that "You have the entire state of Texas," and you have so many people in the state of Texas that there is enough to go around for everyone, is what they would tell you to say.*
>
> ***Interviewer:*** *That makes no sense…*
>
> ***Franchise Recruiter:*** *Yeah, no. It doesn't. If you think about it.*
>
> ***Interviewer:*** *Yeah, because they are telling you to go face-to-face with somebody to develop a relationship, and I don't know how you are going to do that from Dallas to San Antonio*
>
> ***Franchise Recruiter:*** *Yeah, exactly. And it is a lot harder on the phone.*

Investors should not be happy with this expansion either, as the corporate channel has lower margins, in fact, the CEO Mark Jones characterized the corporate channel as a break-even enterprise.[40]

When a GSHD Franchisee Fails, They Can Lose Everything, Even Their Home

GSHD requires that the spouse of a franchisee also sign a personal guarantee as part of the agreement. As the FDD lays out, this puts all marital assets at risk, including the home.

> **Spousal Liability**. *Your spouse must sign a document that makes your spouse liable for all financial obligations under the franchise agreement even though your spouse has no ownership interest in the franchise. This guarantee will place both your and your spouse's marital and personal assets, perhaps including your house, at risk if your franchise fails.*

These are not idle provisions, GSHD will go to court to collect any unpaid debts from a franchisee that still owes a balance on their franchise agreement.[41]

The franchise agreement contains many more one-sided provisions that allow GSHD to get a windfall when the franchisee fails. One such provision is that the GSHD has the option to purchase the franchisee's book of business for a deep discount upon termination of the agreement:

> *18.5.1*
>
> *For assets other than furniture, fixtures or equipment and the rights under the lease for the Approved Location, the purchase price will be an amount equal to one and one-half (1 1⁄2) times the Commissions, net of Royalty Fees, received by the Franchised Business during the twelve-month period immediately preceding the closing of the purchase of the assets by us.*

The option to purchase the book of business at 1.5x the TTM commissions, net of GSHD's substantial royalty fees, is very advantageous for GSHD, since many of these will be homeowners' policies that could be expected to renew for many years. It is our understanding from our conversations with former employees that that the company will not reassign these policies to another franchisee or corporate agent unless the customer calls in to change or assess the account, allowing the company to keep the whole value of the premium instead of splitting it with an agent.

If the failing franchisee is lucky, the amount that GSHD pays for their book will cover any debts they owe. But if they have the misfortune to still owe a balance on their franchise fee, interest accrues at 1.5% a month (18% annually).[42]

GSHD appears to be content to let franchisees fail, since it can create some short-term benefits, but we believe that GSHD is not sowing wisely as the high rate of failure has a negative effect on the company's ability to continue to recruit new franchisees. When we asked a former Franchise Recruiter about the blowback from the high churn rate, they stated:

> *When I was in that specific position, you would call on different agents … and let them know that 'hey I'm in Goosehead Insurance, have you ever thought about the idea [of joining Goosehead]' And they would say, 'oh yeah my friend tried that and went through the process and lost literally all of his money, I hate you guys, please never call me.'*

In our estimation, GSHD's prospects for long-term growth will be seriously hamstrung by a negative reputation earned by churning through the life's savings and homes of people who never were going to succeed, no matter how hard they worked. We expect this to lower the quality of prospective franchisees and only exasperate GSHD's problems going forward.

GSHD Management Claims to Be Aligned with Shareholders, But Has Been Taking Money Off the Table Through Self-Serving Dividends and Stock Sales

In the Q3 2022 earnings call, there was a moment where CEO pointed out that his interests and the long-term interests of the companies were aligned:

> *As Goosehead's largest shareholder and the person with the most to lose if we get things wrong and as someone with an intimate understanding of Goosehead's needs, I'm highly confident that moves we're making are the right ones to drive long-term shareholder value.*[43]

However, when you look at the actions of the CEO, a different message appears. He and his family have already sold ~$610 million in stock. At today's current market price, he and his family's remaining stake is only worth ~$587 million.

When the company IPO'd in 2018, all the proceeds of the IPO went directly to the CEO and the other pre-IPO members to cover a portion of a $114 million in notes that GSHD used to purchase two management fee entities (also owned primarily by the CEO).[44]

GSHD is supposed to be a high growth company, so investors might expect that the company's CEO would be more interested in plowing available capital into accelerating growth. However, GSHD declared special dividends in 2019, 2020, and 2021 of $15 million, $42 million, and $60 million respectively. $59.3 million of the dividends went to holders of Class B shares, of which ~89% are held by the CEO.[45]

These dividends were not really paid out of free cash flows, they were funded primarily *with debt*. GSHD added $109 million in debt from 2020 to 2021, which was more than the dividends paid during the same period.

		2021		2020
Net cash used for investing activities	$	(15,375)	$	(10,333)
Cash flows from financing activities:				
Debt issuance cost	$	(666)	$	(677)
Repayment of note payable	$	(4,369)	$	(27,821)
Proceeds from notes payable		44,619		64,821
Proceeds from the issuance of Class A common stock		4,590		5,040
Member distributions and dividends to stockholders	$	(60,000)	$	(44,697)

The notes payable that GSHD took out to pay for these dividends is a key reason why GSHD has a shareholders' deficit of $45 million (i.e., $45 million in negative equity).

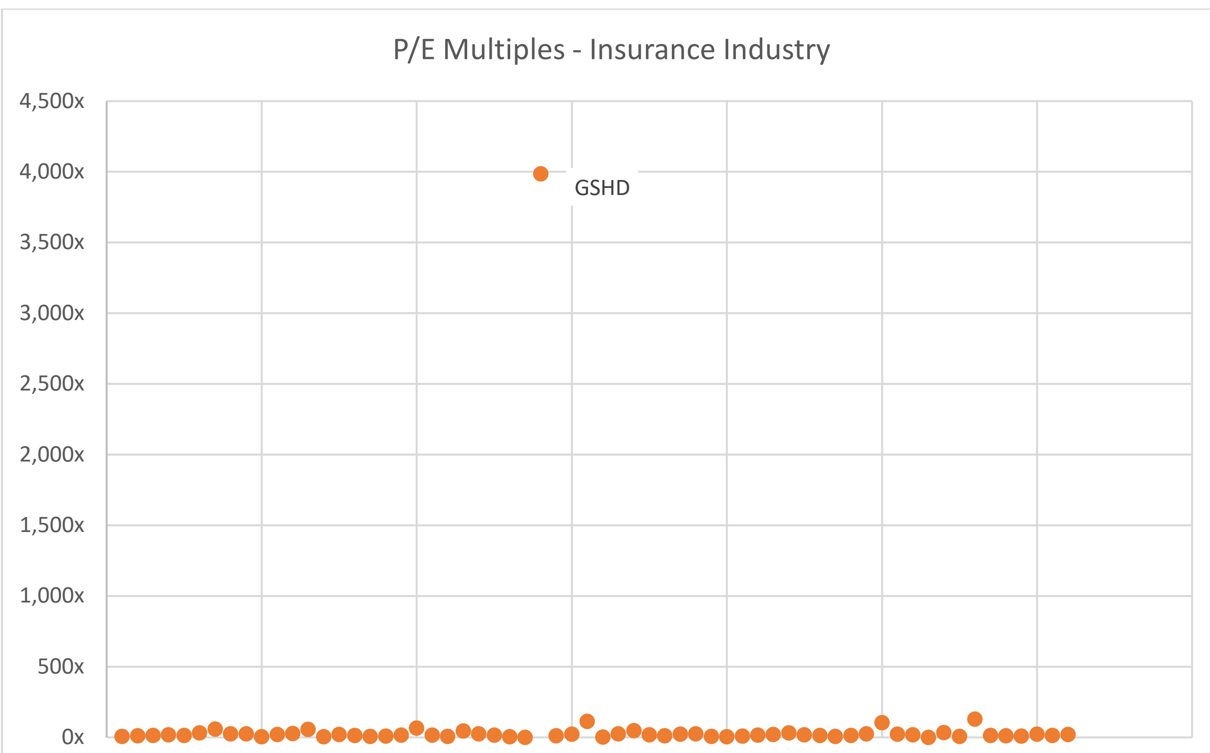
Let us be clear, management signed off on saddling shareholders with $109 million in debt, and personally pocketed more than half of the proceeds while personally carrying none of the risk associated with the debt. Mark Jones and his family members in management hold most of the company's Class B shares, currently giving them 43.3% of the ownership of the operating company.[46]

These Class B shares do not carry all the same rights as Class A shares, but they are entitled to *pari passu* dividend rights (that's Latin for equal-footing) so any dividend issued goes in large part to the CEO his family in management.[47]

Dividends to Pre-IPO LLC Owners	
Date	**Amount**
3/7/2019	$9,038,000
7/30/2020	$22,157,000
7/28/2021	$28,343,000
Total	**$59,538,000**

The directors and officers of GSHD collectively own approximately 97.3% of the Class B shares,[48] so we are not surprised that they were willing to take on debt and issue dividends when most of the borrowed money ended up in their pockets. In our opinion, this amounts to grotesque self-dealing.

As for the shareholding public, they are purchasing GSHD at an eyepopping TTM P/E ratio of 3,984x while, according to data from Bloomberg LP, the average TTM P/E ratio for GSHD's insurance industry peers is only 20.8x, as of the date of this writing.[49]



Through the TRA, the CEO and His Family Can Extract Hundreds of Millions in Cash Out of GSHD Regardless of What Happens to Shareholders

Goosehead went public through a process often referred to as a “supercharged IPO”[50] wherein a holding company is created to purchase a controlling interest the operating company, which is organized as a limited liability company (LLC) and flow-through entity for tax purposes.

A major benefit for the founders of a “supercharged IPO” is that the founders can receive a share of the tax deductions that the company can accrue. First the pre-IPO members of the operating company have their interests exchanged for a new class of units in the LLC that are represented by Class B shares and can be exchanged for Class A shares.

As the founders exchange their Class B shares and the corresponding interest in the LLC for Class A shares, the tax basis for the holding company increases, creating a tax benefit. In GSHD’s case, the TRA allocates 85% of the tax benefit, in cash, to the pre-IPO members.[51]

Thanks to its TRA agreement, GSHD owes the CEO and the other pre-IPO members $112.4 million after they exchanged 6.2 million Class B shares for Class A shares. With 16.2 million more Class B shares to exchange, the CEO and the other pre-IPO members could accrue an *additional* $280 million in cash, and this benefit may not be dependent on the stock price.[52]

When we added in the TRA owed to Jones to the pre-IPO payment, the self-serving dividends, the stock sales, and the executive salaries, the total sum was ~$900 million. When we add in the remaining value of stock held by the CEO and his family at current values, it amounts to $1.5 billion. This is more than the company’s $1.47 billion market cap, and far above the $23.4 million in net income GSHD has managed to produce (of which only ~$12 million is attributable to the investing public due to the company’s structure). It is clear to us that the CEO and his family who run this company do not have their interests aligned with the interests of shareholders.

Conclusion

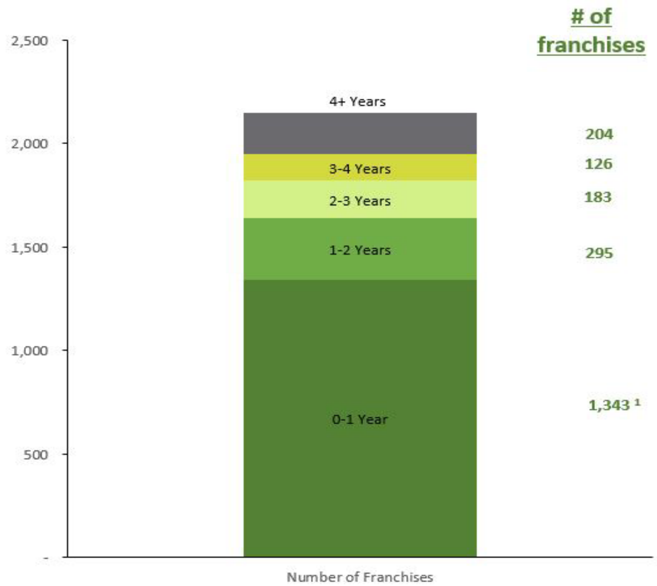
We are short GSHD because analysts consider this a top-tier growth story even though it has only produced $23.4 million in cumulative net income since its IPO, and the downturn in the housing market is upending their business model and driving its franchisees, its engine for future growth, out of business at record rates according to our analysis.

In our conversations with former employees, we have learned that 85%-95% of the company’s leads for new business, which drive growth, come from referral partners tied to home closings and these leads are drying up. Our research also indicates that GSHD will not generate explosive growth in the long-term, even after the housing market recovers, because the corporate channel is cannibalizing their franchisees and high churn and poor returns scare off prospects. Management has no incentive to address these problems because they are the primary beneficiaries of the status quo, and the board has been effectively neutered.

Appendix A: Calculating the Franchisee Failure Rate

According to our Calculations, 67% of Signed Franchisees Failed in 2021

In GSHD's annual report they include a chart that indicates how many franchisees the company has at year-end, and they disclose how long the franchisees have been with the company. In 2022, the company disclosed the following chart:[53]



(1) Number of franchise locations include 953 franchises which are under contract but yet to be opened as of December 31, 2021.

Since the company has disclosed a similar chart in every annual report going back to its S-1, this allows us to track how many of the franchisees that were either signed or operating at the beginning of the year were still operating at the beginning of the next year. This allows us to segment the data by year and track the dropout rate. Here is our analysis:

Franchises By Year	2017	2018	2019	2020	2021	Failure %
0-1 year	250	393	567	905	1343	
1-2 years	67	110	156	208	295	67.4%
2-3 years	42	58	96	140	183	67.7%
3-4 years	38	37	50	90	126	67.9%
Net additions to 4+ yr franchises	nm	34	31	46	79	68.4%
4+ years	14	48	79	125	204	

We can see in the data that the likelihood that a GSHD franchisee will get to its second year has gotten progressively worse since the IPO. The absolute number of franchises is increasing as more prospective franchisees have signed up each year, but the percentage of franchisees that get to their second year has declined every year.

Additionally, getting to the second year is no guarantee of success. A substantial number of franchisees do not survive their second, third, or even fourth years.

GHSD's High Failure Rate is Due in Part to Franchisees Who Never Launch

When GSHD's management team discusses the churn rate for franchisees the number they offer is far lower than the one we calculated. According to management, churn for franchisees is historically 15%, but it waned down to single digits during the pandemic, and is waxing to more than 25% in Q4, 2022.[54] In contrast, according to our calculations, the number of franchisees that failed to get to a second year started at 56% in 2018 and has grown to eclipse 67%.

The difference is due in part to the fact that GSHD talks about their failure rate as a percentage of all franchisees instead of franchisees in their first year, which mutes the signal. Another reason our calculations are different from GSHD's is because we include franchisees who sign their agreements but fail to launch, while GSHD omits this group from their calculations.

In our conversations with employees, we learned that franchise recruiters were initially compensated based on how many franchisees they signed, instead of getting compensated for the ones that launched.[55] Additionally, we have also learned that franchisees do not pay their initial fee upon signing the franchise agreement, but immediately prior to training, which is the precursor to launch.

This created a perverse incentive whereby franchise recruiters would engage in boiler-room sales tactics (described by one former employee as predatory)[56] to get people to sign a franchise agreement, knowing full well that the person was unlikely to follow-through.

In the Q3 Earnings Call, Mark Jones Jr. stated that the company was trying to address this issue and reduce the number of people in the pipeline who would never launch.[57] If GSHD is successful in changing the incentive structure so the company reduces the number of franchisees who sign but never launch, then that could improve the failure rate, even as the number of operating franchisees that shutter their existing businesses skyrockets due to unfavorable conditions in the housing market in 2022.

There is also a lack of clarity as to whether a signed, yet unlaunched franchisee is booted out of the system or is rolled over to next year's list of franchisees in the 0-1 tenure category as disclosed above.[58]

The reason why we think it is important to include GSHD's signed-but-never-launched franchisees is because GSHD includes them in its reported franchisee numbers. GSHD trumpets its franchisee number and even describes them as franchise locations in presentations, only footnoting the fact that a large portion of the franchisees have not launched[59] and therefore cannot have a location.

Appendix B: Taking Over $900 Million Off the Table

Our analysis indicates that the CEO and the other pre-IPO members have taken more than $900 million off the table through a combination of different methods since the IPO.

Item	Cash value
Stock sales	$609,862,732
Dividends	$59,538,000
Compensation	$14,710,950
Pre-IPO Reorg. Payment	$114,000,000
TRA Payments Owed	$112,400,000
Total	**$910,511,682**

Firstly, they received $114,000,000 from the pre-IPO reorganization, including all of the $98.1 million GSHD raised in its IPO.[60]

Secondly, Mark Jones and his immediate family have sold 9,256,617 shares of stock for total proceeds of $609,862,732.

Thirdly, the pre-IPO holders have received $59,538,000 in cash dividends.

Fourthly, the pre-IPO holders are currently entitled to a TRA payment of $112.4 million as of Q3 2022.[61]

And finally, Mark Jones and his family members have received ~$14.7 million in executive compensation since the IPO.[62]

Citations

[1] To be clear, what we characterize as a failure for a signed franchisee is when a signed franchisee fails to progress from their first year to their second year. GSHD p 14, 2020 10-K and p. 15 2021 10-K, p 15 (905 franchisees had 0-1 years of tenure on December 31, 2020, and only 295 of franchisees had 1-2 years of tenure on December 31, 2021} See Appendix A for more detail explanation of our analysis.
[2] See Appendix B
[3] See Goosehead Insurance FDD, p 41, Item 19, Financial Performance Representations, dated 4/6/2022 (We calculated take home pay as gross commissions minus the 20% fee GSHD takes on new commissions.
[4] Q3 Earnings call, Mark Miller Comments (all Earnings Transcripts via Bloomberg. L.P.)
[5] GSHD, 10-Q, 12, 10/27/2022
[6] In Q1, Q2, and Q3, the company disclosed onboarding a total of 398 franchise locations. During that period the company's number of operating franchise locations only increased by 205 from 1,198 as disclosed in the 10-K to 1,403 in Q3 10-Q. Since 398 locations were onboarded, but the overall number of operating franchises only increased by 205, it appears that 193 locations closed during this period.
[7] Existing Home Sales (single family homes), and MBA US Mortgage Application Volume NSA (Weekly as of 12/16/2022): 170.40, via Bloomberg L.P.
[8] GSHD Q3 2022 Earnings Press Release, p. 13
[9] GSHD Form S-1 filed April 2, 2018, Exh. 10.5: Stockholders Agreement, Section 1.01(f)
[10] The plaintiff's LinkedIn page indicates that he is still a franchisee
[11] Mickey Dollens v. Goosehead Insurance, Chancellery Court of DE, Case No. 2022-1018, filed on Nov. 10, 2022
[12] Q3 Earnings Call, Comments by Mark Jones Jr. asserting increased churn was healthy.
[13] In the Franchise Agreement form included as Exhibit 10.6 in in the company's 10-K, the company lays out conditions for termination in Section 17. These include *automatic* termination for bankruptcy or receivership of the franchisee. Termination *with notice* if the franchisee does not lease an approved location within 90 days, abandonment of the business, felony conviction, unauthorized transfer of the business, breach of a covenant, three or more defaults, keeping fraudulent books, misuse of marks etc… Termination *with notice and an opportunity to cure* if there is default to GSHD, an affiliate, or any other contract.
[14] Mark Miller, Q2 Earnings Call.
[15] Mark Miller, Q3 Earnings Call.
[16] See infra fn. 5
[17] Goosehead Insurance FDD, p 41, Item 19, Financial Performance Representations, dated 4/6/2022
[18] See Goosehead Insurance FDD, p 43-48, Table No. 3 Status of Franchise Outlets, dated 4/6/2022.
[19] Mark Jones, Q1 Earnings Call.
[20] Goosehead Insurance FDD, p 20, dated 4/6/2022, (Franchise Agreement, Section 4.5 Late Payment)
[21] Goosehead Insurance FDD dated 04/06/2022, p. 5.
[22] This structure is known as an "Umbrella partnership-Corporation" or "Up-C" structure: "The Up-C Structure in IPOs" by Mayer Brown Legal Services, May 2019
[23] GSHD, 10-Q, 21, 10/27/2022
[24] GSHD, Def-14A, p.34
[25] This is meant to be a ballpark figure, there are different factors in the tax accounting that could have a significant impact on the final tally for the monetary benefit that the TRA will bring Mark Jones and the other pre-IPO holders.
[26] Stockholders Agreement, 2, Exhibit 10.4, GSHD 10-K, 2/28/2022
[27] GSHD, Def-14A, p.34
[28] Interview with Former Account Executive, 11/16/2021, (quotes from former employees were transcribed and have been edited for clarity and relevance).
[29] Comment from Mark Jones, Earnings Call Q3, Transcript via Bloomberg LP:

> *only about 20% of our revenue is exposed to the housing market from transactions tied to home closings. The remaining 80% comes from referrals and renewal business.*

[30] Q2 Earnings Call, Mark Miller, Transcript via Bloomberg LP.
[31] [Q3?] Earnings Call, In response to an analyst's question about what franchisees are doing to counterbalance the slow-down in the housing market, Mark Jones stated:

> *[I]n terms of how they allocate their time, basically, when you have fewer leads coming in, you have more time to do business development outreach and develop more referral partner relationships.*

[32] See fn 5.
[33] Q3 Earnings Call, Comments from Mark Jones Jr.:

[Positive same-store sales] has ***been offset in the near-term by higher churn of franchises, which ran at 25% annualized in the quarter*** *compared to 21% in the second quarter and a roughly 15% historical average.* ***We expect higher churn in the near-term*** *as we make up for high-single-digit churn than we allowed through most of the pandemic.*

[34] GSHD, 10-K, Exhibit 10.5 Form of Franchise Agreement, Section 17: Default and Termination, 2/28/2022

[35] See Appendix A for calculation method.

[36] In the company's form promissory note it appears that typically a franchisee will pay $500-$833.33 per month depending on which state the franchisee is located.

[37] See Goosehead Insurance FDD, p 43-48, Table No. 3 Status of Franchise Outlets, dated 4/6/2022.

[38] Glassdoor reviews from Texas-based employees of GSHD frequently complain of the saturation of the referral partner market. Here is a typical example:

Overmatured market -every loan officer has been called on in the state of Texas and most of them will never do business with Goosehead again because at some point the ball was dropped, their agent quit, or because we keep on calling them.

[39] Goosehead Insurance FDD, p 43-48, Table No. 3 Status of Franchise Outlets, dated 4/6/2022.

[40] Q2 Earnings Call, Comment from Mark Jones:

As you know, if you looked at that essentially product line profitability yield, ***you will see that the Corporate Channel is sort of break-even****, it's a break-even enterprise, and it's strategically essential because we use it for product process and technology R&D*

[41] Goosehead Insurance Agency v. Laseni Williams, Superior Court of California, County of San Diego, 37-2020-00001200-CU-BU-CTL. (GSHD sued their former franchisee whose franchise was terminated in her second year for $26,000).

[42] FY 2022 FDD p. 20, Form Promissory Note

[43] Q3 Earnings Call, Transcript via Bloomberg, L.P.

[44] GSHD, S-1/A, 45, 50, 4/17/2018

[45] GSHD Def 14A, 35, 3/22/2022

[46] GSHD holds 56.7% of the ownership of the underlying company, Goosehead Financial, LLC (GF). Mark Jones and the other pre-IPO holders own the rest of GF, and their interests are represented by the Class B shares. Jones and the other directors own 97.36% of the Class B shares, and 7.45% of the Class A shares. Def-14A, 35, 3/22/2022

[47] The percentage ownership of the underlying company held by Mark Jones and the other Class B shareholders has diminished overtime. In their S-1/A the class B members held 65% ownership, and that had fallen to 43.3% by Q3. GSHD explained its treatment of Class B shares in a Correspondence with the SEC, dated March, 15, 2018

[48] GSHD Def 14A, 35, 3/22/2022

[49] Average P/E ratio of the 62 largest publicly traded, US listed insurance companies as of 01/04/2023, per Bloomberg, LP.

[50] Carpenter Wellington PLLC, 12/18/2020, *Supercharged IPOs and the Up-C Structure in IPOs: How It Works*, *Lexology.com*

[51] GSHD, S-1/A, 16, 4/17/2018

[52] This is meant to be a ballpark figure, there are different factors in the tax accounting that could have a significant impact on the final tally for the monetary benefit that the TRA will bring Mark Jones and the other pre-IPO holders.

[53] GSHD 2021 10-K, p. 15, filed 02/28/2022

[54] Q3 Earnings Call, Comments from Mark Jones Jr.

[55] Conversation with former Territory Manager, 11/23/2022

[56] Conversation with former employee, 11/23/2022.

[57] Q3 Earnings Call, Comments from Mark Jones Jr.

[58] There is reason to believe they do not roll over, since according to the Site Selection Addendum to the Franchise Agreement, people who sign an agreement have 90 days to lease a location or they are automatically terminated. However, at least one former employee indicated that franchisees who had signed but failed to launch had the option to stay on if they were still interested. This would indicate that these franchisees could roll over and be counted in the 0-1 tenure category year after year. This would theoretically reduce what we characterize as its dropout rate, but would also make their total franchise numbers very misleading, since it would be inflated by "ghost" franchisees who sign but never launch. We also believe it is accurate to say that a signed-but-never-launched franchisee that is staying in the system year after year is a failure.

[59] Investor Presentation, November 2022, p. 9

[60] GSHD, S-1/A, 45, 50, 4/17/2018

[61] GSHD, 10-Q, 19, 10/27/2022

[62] Def-14A, Executive compensation tables, 2018, 2019, 2020, 2021

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