



**Trupanion, Inc.**

**Third Quarter 2024 Earnings Conference Call**

**October 30, 2024**

## C O R P O R A T E P A R T I C I P A N T S

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**Margi Tooth**, *President and Chief Executive Officer*

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## C O N F E R E N C E C A L L P A R T I C I P A N T S

**Maria Ripps**, *Canaccord Genuity*

**John Barnidge**, *Piper Sandler*

**Brandon Vazquez**, *William Blair*

**Josh Shanker**, *Bank of America*

**Jon Block**, *Stiefel*

**Katie Sakys**, *Autonomous Research*

**Wilma Burdis**, *Raymond James*

## P R E S E N T A T I O N

### Operator

Good day, and welcome to the Trupanion Third Quarter 2024 Earnings Conference Call.

All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key, followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your telephone keypad. To withdraw your question, please press star, then two. Please note we do ask that you limit yourself to one question and one follow-up whilst in queue.

Please also note that today's event is being recorded.

I would now like to turn the conference over to Gil Melchior, Director of Investor Relations. Please go ahead.

### Gil Melchior

Good afternoon, and welcome to Trupanion's third quarter 2024 financial results conference call.

Participating on today's call are Margi Tooth, Chief Executive Officer and President, and Fawwad Qureshi, Chief Financial Officer.

For ease of reference, we've included a slide presentation to accompany today's discussion, which will be made available on our Investor Relations website under our Quarterly Earnings tab.

Before we begin, please be advised that remarks today will contain forward-looking statements. All statements other than statements of historical facts are forward-looking statements. These include, but are not limited to, statements regarding our future operations, key operating metrics, opportunities and financial performance, pricing and veterinary industry inflation, and our ability to remediate our material weaknesses. These statements involve a high degree of known and unknown risks and uncertainties that could cause actual results to differ materially from those discussed. A detailed discussion of these and other risks and uncertainties are included in today's earnings release, as well as the Company's most recent reports, including Forms 10-K, 10-Q, and 8-K, filed with the Securities and Exchange Commission.

Today's presentation contains references to non-GAAP financial measures that Management uses to evaluate the Company's performance, including without limitation, cost of paying veterinary invoices, variable expenses, fixed expenses, adjusted operating income, acquisition costs, internal rate of return, Adjusted EBITDA, and free cash flow. When we use the term adjusted operating income or margin, it is intended to refer to our non-GAAP operating income or margin before new pet acquisition and development expenses.

Unless otherwise noted, all margins and expenses will be presented on a non-GAAP basis, and excluding stock-based compensation expense and depreciation expense. These non-GAAP measures are in addition to, and not a substitute for, measures of financial performance prepared in accordance with the U.S. GAAP. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to the most directly comparable GAAP results, which can be found in today's press release or on Trupanion's Investor Relations website under the Quarterly Earnings tab.

Lastly, I would like to remind everyone that today's conference call is also available via webcast on Trupanion's Investor Relations website. A replay will also be available on the site.

With that, I'll hand it over to Margi.

### **Margi Tooth**

Thanks Gil, and good afternoon, everyone.

I'm pleased to share the results of a very strong quarter. Most notably, growth in our subscription adjusted operating income accelerated by 66% over the prior year period. Our subscription adjusted operating margin reached 14% in the quarter, the highest level since quarter one of 2022, which represents a 390 basis point year-over-year improvement. The biggest driver of this result was the achievement of our value proposition to 71%, a milestone we were pleased to reach against the backdrop of the greatest veterinary inflation seen in a generation.

Over the past 18 months, as inflation rolled through hospitals across North America, the team has been working hard to restore the margins in our core subscription business. Getting back on track required us to take some significant rate increases to return to our target value proposition and pull back on our acquisition investments until our pricing and the cost of care were more closely aligned. With strong levels of rate now being earned through our book and ongoing expense discipline across the operations, we are well positioned to achieve a 15% subscription adjusted operating margin for Q4.

As a reminder, our goal is to achieve a 15% adjusted operating margin within our subscription business on an annual basis. This has been our guiding objective for many years, and as we move ever closer, it will continue to be our target to ensure that as a low-cost operator, we can offer our members lifetime coverage at the highest value proposition in the market. It takes collective commitment from the teams to operate so close to our long-term model P&L, and after months of significant margin pressure, we are now approaching a sustainable margin position and turning to growth from a position of strength.

Our operating model requires us to be efficient, lean, vertically integrated, and focused. This allows us to reduce frictional costs, which in turn creates a white-glove member experience, high lifetime value, and greater sums of capital to spend on growth acceleration. Our biggest markets today, Canada and the United States, are still dramatically underpenetrated at approximately 4%. The opportunity is enormous, and with the humanization of our pets continuing, the demand and need to enable access to care increases with it.

Back to our results. Revenue for our subscription segment grew 20% in Q3. In terms of our cost of paying veterinary invoices, while the trends in July were slightly better than anticipated, August and September were roughly aligned with prior quarters, leaving the full quarter reflecting a minor deceleration of about 1 percentage point versus the first half of the year. As a result, we continue to assume 15% veterinary inflation.

Over the last 12 months, about half of our book has received a pricing increase of 20% or more, and retention for this group continues to perform well and is trending up year-over-year, despite many receiving consecutive double-digit adjustments to their new monthly premium. We credit this improvement largely to the focus of the team, evolving communications, and enhancing member experience.

Our retention for those with increases below 20% also performed well, despite a larger proportion of members now experiencing price increases in the high teens. The strength in both cohorts demonstrates the value and resilience of our product and our member experience. Our efforts now are shifting back to the retention of our members in their first year, which is trending below our expectations. Enhancement of this experience is underway and will continue, as the size of this cohort should become larger over time. It's worth noting the nature of any member experience changes take time to take full effect across an entire cohort.

I'm pleased, however, to share some tangible results today regarding the evolution of our technology platform. With our claims migration nearly complete, we are seeing significantly improved service levels, continued increases in invoices paid directly to the hospital, and record levels of claims automation, all key elements of an exceptional member experience. Additionally, and importantly, we saw efficiencies in our invoice processing costs, which hit a new low as a percentage of subscription revenue. I am eager to see the benefits this new system will bring to first-year retention and all aspects of our business and member experience.

Now, turning to our new pet growth. In the third quarter, we spent \$16.8 million, an increase of 4% over the prior year period, to enroll approximately 65,800 new subscription pets. This resulted in an average pet acquisition cost of \$243 and an estimated internal rate of return of 36%. Of particular note this quarter, we saw a healthy sequential increase in the number of active hospitals, defined as hospitals that enrolled at least one pet in the prior 90 days.

Moving to our broader portfolio, our newer initiatives, including our powered by suite of products with Chewy and Aflac; our medium and low ARPU products, Furkin and PHI Direct; and our products in continental Europe, comprised approximately 15% of our gross new pet ads in the quarter, and only 10% of our pet acquisition spend.

In September, we launched our first Trupanion-branded product in Europe to the 29 million pet parents in Germany and Switzerland. This launch opens the opportunity for us to bring Trupanion's unique high-value product to another underpenetrated market.

As we now look forward, it will be important to gain momentum in new pet enrollments. While we will not sacrifice our IRR and free cash flow targets to do so, we intend to deploy an increasing amount of our adjusted operating income to acquire pets in the upcoming quarters. After spending so little for the past 12 months, we expect the impact of dining-up investment to take some time to truly accelerate growth, and we have room for improvement in our execution. With an increasing lifetime value and the timing lag of our spending, we anticipate per-pet spend to increase on a dollar basis as we ramp back up to higher pet ads.

Our truly unique offering in the industry presents a much-needed, reliable solution in making pet care affordable. Our approach to comprehensive coverage, specifically within the core Trupanion product, ensures pets receive the care they need without delay, resulting in higher customer and veterinary satisfaction, as well as exceptional lifetime value. We are proud to lead the industry.

The Company embraces its role as a leader in this category with purpose and passion, and for years we have been at the forefront of industry discussions to drive fundamental change to the way medical insurance for pets is perceived. While still very much a fledgling industry, we are seeing a shift in how we're viewed and regulated, most notably with the adoption of model law across an increasing number of states in the U.S., and the recent news of the NAIC changes to the underwriting risk factors applied to the risk-based capital requirements calculation.

This change alone is a huge development for us, significantly lowering a barrier we experienced historically and ultimately resulting in more funds to grow. These changes are the primary driver of our estimated capital requirements decreasing by 24% since the end of 2023. We anticipate there will be an additional reduction to our capital requirements next year from the already announced 2025 factors. These ongoing developments give us greater confidence in the long-term recognition of our industry and the nature of its risks.

Before I hand over to Fawwad, I'd like to share news of a very meaningful milestone for Trupanion. In a short time, we expect to cross \$3 billion in paid veterinary invoices within our subscription segment. It took us 20 years to pay out the first billion, a little less than three years to pay out the second, and now less than two years to pay the third billion. Crossing this milestone is a testament to the very real impact we're making and the breadth of our coverage, helping and saving countless pets' lives. This achievement is not just a milestone. It's a celebration of the purpose that drives Trupanion every day and a reminder of the progress we're making.

With that, I'll hand it over to Fawwad to provide a detailed overview of our Q3 results.

### **Fawwad Qureshi**

Thanks, Margi, and good afternoon, everyone.

Today, I'll share additional details on our Q3 performance as well as provide our outlook for the fourth quarter and full year 2024.

We had another strong quarter, with total revenue and adjusted operating income coming in ahead of expectations. Total revenue for the quarter was \$327.5 million, up 15% year-over-year. Within our subscription business, revenue was \$219 million, up 20% year-over-year. Total monthly average revenue per pet for the quarter was \$74.27, up 13% over the prior year period.

Within our core Trupanion brand, ARPU expanded even faster, at 14% year-over-year. Total subscription pets increased 6% year-over-year to over 1,032,000 pets as of September 30. This includes over 48,000 pets in Europe, which are currently underwritten by third parties.

Average monthly retention for the trailing 12 months was 98.29%, down versus the third quarter last year, which was 98.55%. On a trailing three-month basis, retention was down from the second quarter this year and approximately in line with the first quarter. The subscription business cost of paying veterinary invoices was \$155.5 million, resulting in a value proposition of 71%, down from 75.9% in the prior year period.

We achieved our 71% target value proposition a quarter earlier than expected. The drivers of this improvement were margin expansion from our ongoing pricing actions, continued efficiency in our cost of processing invoices, and the trends in veterinary inflation that Margi referred to. The quarter also benefited from prior period development of \$0.5 million, or approximately 20 basis points of revenue.

As a percentage of subscription revenue, variable expenses were 9.4%, down from 9.5% a year ago. Fixed expenses as a percentage of revenue were 5.6%, up from 4.4% in the prior year period in line with our expectations. This is the result of ongoing investments in our technology and controls infrastructure. After the cost of paying veterinary invoices, variable expenses, and fixed expenses, we calculate our adjusted operating income.

Our subscription business delivered adjusted operating income of \$30.8 million, an increase of 66% from last year. Subscription adjusted operating margin was 14% of subscription revenue. This is up from 10.1% in the prior year and represents approximately 390 basis points of margin expansion as pricing takes hold. This represents the highest adjusted operating margin in two and a half years, and the highest Q3 since 2021.

Now, I'll turn to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and a lower margin profile than our subscription business. Our other business revenue was \$108.5 million for the quarter, an increase of 5% year-over-year. The decelerating growth within this segment is expected as one of our partners, Pets Best, continues to enroll pets with their new underwriter.

Adjusted operating income for this segment was \$1.8 million, a decrease of 65% from last year, driven by lower gross margin and higher fixed expenses. The lower gross margin is consistent with our revised agreement with Pets Best, which has lower capital requirements and a different margin profile. In total, adjusted operating income was \$32.6 million in Q3, up 37% from Q3 last year and ahead of our expectations.

In Q3, our higher margin subscription business comprised approximately 94% of our adjusted operating income. This is up from 84% for the full year in 2023. As Margi mentioned earlier, we acquired approximately 65,800 new subscription pets in the quarter and deployed \$16.8 million to do so. Excluding the approximate 3,700 new European pets that are underwritten by a third party, this translated into an average pet acquisition cost of \$243 per pet in the quarter, up from \$212 in the prior year period. The estimated internal rates of return on this spend was 36% in the quarter, in line with our targets of 30% to 40%.

We also invested \$1.5 million in the quarter in development costs. Stock-based compensation expense was \$8.1 million during the quarter.

We reported net income for the quarter of \$1.4 million, or \$0.03 per basic and diluted share, compared to a net loss of \$4 million, or \$0.10 per basic and diluted share, in the prior year period. This represents a year-over-year improvement of \$5.5 million.

In terms of cash flow, operating cash flow was \$15.3 million in the quarter, compared to \$11.4 million in the prior year period. Capital expenditures totaled \$1.9 million, down from \$4.4 million in Q3 last year. As a result, free cash flow was \$13.4 million, a \$6.4 million improvement from the prior year's third quarter.

On our third quarter 2023 earnings call, we introduced an annual free cash flow target at 2.5% of revenue. I am pleased to report that we are making fantastic progress towards this goal, and have now generated \$30 million of free cash flow over the last four quarters. This represents an improvement of \$48 million over the prior four quarters.

Turning to the balance sheet. We ended the quarter with \$293.1 million in cash and short-term investments. Outside of our insurance entities, we held \$36.4 million in cash and short-term investments, with an additional \$15 million available under our credit facility. At the end of the quarter, we maintained \$274.6 million of capital surplus at our insurance subsidiaries, which was \$139.9 million more than the estimated risk-based capital requirement of \$134.7 million. Excess capital has increased by \$75.8 million year-to-date due to the NAIC changes that Margi spoke about, the retained earnings in our insurance companies, and the slowing growth in our other business.

I'll now turn to our outlook. We are increasing our full year revenue guidance, which is now expected to be in the range of \$1.281 billion to \$1.286 billion, representing 16% growth at the midpoint. We are narrowing the range for subscription revenue, which is now expected to be between \$856 million and \$858 million. The midpoint of the range is increasing and represents 20% growth year-over-year.

We are also increasing our adjusted operating income guidance to take into account our overperformance in the third quarter. Our total adjusted operating income for the full year is now expected to be between \$114 million and \$117 million. This raises the midpoint of the range, representing 38% year-over-year growth.

For the fourth quarter of 2024, total revenues are expected to be in the range of \$333 million to \$338 million, representing 13% year-over-year growth at the midpoint. Subscription revenue is expected to be in the range of \$227 million to \$229 million, or 19% year-over-year growth at the midpoint.

Total adjusted operating income is expected to be in the range of \$35 million to \$38 million. We continue to target a 15% subscription adjusted operating margin for Q4. As a reminder, our revenue projections are subject to conversion rate movements predominantly between the U.S. and Canadian currencies. For the fourth quarter of 2024, we used a 74% conversion rate in our projections, which was the approximate rate at the end of September.

With that, I'll hand it back to Margi.

### **Margi Tooth**

Thank you, Fawwad.

Before we move to questions, we'd like to thank the investors and analysts that made the trip over to Seattle to join us at our Investor Day in September. It was a valuable opportunity for us to hear about the key risks and questions that are top of mind for investors. We hope you found the occasion to hear from our team equally valuable.

With that, we'll open it up for questions.

### **Operator**

Thank you. We will now begin the question-and-answer session. To ask a question, you may press star, then one on your telephone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. If at any time your question has been addressed and you'd like to withdraw your question, please press star, then two. We do ask that you limit yourself to one question and a single follow-up. At this time, we'll pause for just a moment to assemble our roster.

Today's first question comes from Maria Ripps with Canaccord. Please go ahead.

**Maria Ripps**

Great. Thank you so much for taking my questions. First, I know you're not providing 2025 guidance at this point, but what are some key considerations as we think about adjusted operating income margin for next year, given better-than-expected trends here in the near term? If inflation remains consistent or maybe even decelerates a little bit from here, could we see subscription adjusted to our margin exceed your 15% target?

**Fawwad Qureshi**

Yes, this is Fawwad. I can take the question. Thanks for asking. Yes, a couple of things just in terms of the way we're thinking about 2025. Of course, we're going through the process of planning 2025 now. That'll end as we close out the year, and then we'll provide the formal guidance in our Q4 call. I think a couple of things that we're looking at that are macro factors, of course, given that pricing has led, from a source of revenue perspective, the majority of our revenue growth this year. Pricing and seeing the retention maintained and stabilized, that's going to be an important factor.

Then, obviously, from an expense management perspective, we've done a very good job. This quarter in particular, we came in very close to what we had expected from a fixed and variable expense perspective. Maintaining the discipline around that are also going to be factors. Then, of course, those things that are outside of our control, the largest being inflation.

**Maria Ripps**

Got it. That's very helpful. Then a quick follow-up. As you continue to ramp your pet acquisition spend, what portion of the incremental spend should be allocated to onboarding more territory partners versus digital or any other channels? Then are there any channels or geographies that you're leaning into more aggressively than you've done in the past?

**Margi Tooth**

Yes. Hi, Maria. When we think about the increase in our pet acquisition dollars, we'll be really focused largely on the conversion element of what we're doing. We've been generating some really nice lead volume from the vet channel and other channels that have worked within our ecosystem for some time. Territory partners, we have a very big group of territory partners. I think it's a record size that we have today. So, not looking to expand that group of individuals. But we will be looking at deploying a lot more from a digital perspective and looking to help drive education in terms of why Trupanion, why insurance, and helping to inform people as they make that conscious decision.

Any channels we're going to lean into differently to historical activity? Not really. We'll just incrementally start pushing both from a lead perspective, a conversion point of view, and then looking at that first year as well. Across the board, those pet acquisition dollars will start to build up in a number of different areas as we look to expand that pet count.

**Operator**



Thank you. Our next question today comes from John Barnidge with Piper Sandler. Please go ahead.

**John Barnidge**

Good afternoon. Thank you for the opportunity. Could you maybe walk us through some of these capital relief from NAIC changes in pet insurance? What are your expectations to that impact? You talked about factors being changed for next year. Has the growth penalty been removed? Trying to understand that a bit better. Thank you.

**Fawwad Qureshi**

Yes, I can take that. Thanks for the question. A couple of things. We talked in our last quarter call about the NAIC factor changes and just the overall increase in our excess relative to the required levels. We began the year \$64 million overcapitalized relative to that requirement. We're now just shy of \$140 million, \$139.9 million was the reported number. We've effectively doubled relative to the requirement. I spoke about it last quarter in terms of contributions. The NAIC factor change has been the most significant driver, along with the decline in the growth rate of Pets Best. If you think about proportional contribution, the change in the requirements, think of that as a little more than half. Then the remaining part, a little less than half, is the retained profits. As we continue to grow the business, per the requirements of our MGA agreement, we contribute. It's a combination of those two.

I think I can speak specifically to the factor changes to give a little bit of context on those. There are more impactful changes related to, if you look at the specific guidelines, the risk lines, both 4 and Line 8. These are updates that don't occur every year. These were more infrequent. There are annual changes that happen, and that's noted on Line 1. If you look at the disclosure and the specific documentation around it, that hopefully gives you a little more illumination in terms of the change. It's the Line 4 and the Line 8 changes. Again, those don't happen regularly. Those are the biggest contributors to the reduction in the requirement.

**John Barnidge**

Thank you for that. Then my follow-up question, is there any update on the material weaknesses from earlier in the year? Are you able to size the remediation costs in the quarter for that? Thank you.

**Fawwad Qureshi**

Yes, there's a couple things I can say about that, now that we've progressed through the year. As a reminder to everyone, as part of the 2023 annual audit, we did have a finding of two material weaknesses. Auditors provide two opinions. They provide one on controls and one on financials. In our case, the issues were on the control side. As we've spoken about, we've taken this extremely seriously. It's remained a top priority throughout the year. You see the increase in fixed expense, both year-over-year, and looking back over the last two quarters. That's been investments we've made to enhance our controls regimen and obviously proceed with the remediation process. We brought PwC in also to help advise.

When you think about this process we're going through, there are really three phases. The first is you define the scope. You try to determine what systems are in scope and what systems are out of scope. The second is to actually design those controls. Then the third, which is the phase we're in right now, is to operate those controls. Depending on the type of control, they have to be in place for a period of time. In some cases, they have to operate successfully for months. In some cases, they're quarterly controls. We're in that third phase. I would say our scoping and design phases. Those are largely complete. We expect to receive EUI's audit opinion sometime in February, commensurate with the filing of our 10-K.

The only other thing I'd say is longer term. I've spoken about it before. I think it's important to emphasize that we look at this not just as an investment in the remediation of these issues, but actually an investment in building an infrastructure of controls that will position the Company to be able to grow what we hope is the next billion of revenue. On an ongoing basis, this is going to be something that we're going to maintain. Fixed expenses have been elevated as a result of that. I think one of the things that is good about or remarkable about the model P&L is, because we set budgets as a percent of revenue, fixed expense at 5%, it gives us an opportunity to grow into that expense base. We'll be looking to do that over the coming year.

#### **Operator**

Thank you. Our next question today comes from Brandon Vazquez with William Blair. Please go ahead.

#### **Brandon Vazquez**

Hi, everyone. Thanks for taking the question. I wanted to follow-up on maybe the 2025 question, but I'll ask it a little bit differently, given now that a lot of some of your important operating metrics are stabilized, some of them improving, like profitability. You can start to turn the wheels back on on the growth algorithm here. The question being, can you talk to us a little bit more about the sequential cadence of when you start to spend some of that money, where do we see it in the P&L, and how long does it take to start seeing some of that impacting the P&L over the coming quarters and into '25?

#### **Margi Tooth**

Yes. Hi, Brandon. Thanks for the question. We're excited this past quarter. It's the first quarter in six we've been able to increase our pet acquisition spend as the margin has bounced back out from compression, and really pleased to be in a position now to start accelerating that pet count. To your point, what we would expect to see is a little bit of time for that incremental PAC investment to start to drive the market, both from an education perspective but also not forgetting the overall lead generation and the first-year retention.

We turned down our spend, if we look back at historical performance, we turned down our spend for the first time in Q1 of 2023. It took us four quarters before that spend really started to lose its efficacy in the market. We would expect to see a similar build back up again in terms of the delay from the initial PAC spend and then helping to really move the funnel. I'd expect in time to see that pet count start to build nicely as we have more investment in the market.

The great news is we have the tailwind of the ARPU today. We have the loss ratio right where it needs to be in terms of that 71%. We're now moving into a period where those adjusted operating income dollars are greater. It allows us to deploy more to invest. We will do so very diligently as we've addressed before within our guardrails and with our 2.5% free cash flow target of revenue as well. Overall, I think it's going to take us a little bit of time but I'd fully expect higher pet count in 2025 as we increase those dollars over time.

#### **Brandon Vazquez**

Okay. Great, thank you. Then maybe as my follow-up. Margi, you had made a comment about I think it was the month of July was trending a little bit lower or more favorable to you guys in terms of that inflation. I'm just curious if you could talk a little bit about what are you seeing in end markets right now? It's an interesting comment that things were a little lower and then they rebounded. Also, just a follow-up on that, did that impact the P&L for either a good guy or a bad guy in the quarter that we should just keep in mind? Thank you.

**Margi Tooth**

Yes, sure. In July, as I did mention, you're right, Brandon, we did see a different cadence in terms of our invoices, our cost of care. That didn't maintain at a lower level for August and September which netted out being slightly lower than our 15% for the full quarter. We haven't seen enough data to suggest that we should be adjusting our assumption when it comes to inflation and so we're still seeing a 15% as we cruise into Q4. Largely anticipate that's because of the problem that Trupanion's product solves, that people are going into pet hospitals and they're not waiting for their pet to be seen, so it's what we would expect and what the audience were working with.

I think in terms of the impact in the P&L's quarter, that naturally leads into the loss ratio. We hit that 71%. That was ahead of expectations which is good, and we would expect as we go into the back half of the year we've got some nice ARPU flow through. We've seen, as we said we would, that buildup of the ARPU growth at record levels so given that that's still flowing through into Q4 then we feel very good about the rest of this quarter.

**Operator**

Thank you. Our next question today comes from Josh Shanker with Bank of America. Please go ahead.

**Josh Shanker**

Thank you for taking my call. Good afternoon to everyone. I want to talk about retention a little bit and sometimes you give us some detail about retention by cohort. I'm wondering if the percentage of Trupanion customers who are receiving a 20% or greater increase has gone up from where it went a year ago? And, if you can talk to your projections about when you think the retention should bottom and begin to go the other way.

**Margi Tooth**

Yes. Hi, Josh. Ultimately, we're quite pleased with retention performance, and to your point we have always looked to the cohorts for attention in three different buckets to really help us articulate the message at that point in time for our member. With such a high rate flow coming through, frankly, at unprecedented levels, we would have expected a shift down and we have seen that for sure. Through the course of these rate increases though, just to put it in perspective, we've added around \$10 million in revenue from those rates that we've gained back over the past four quarters which has offset the \$2 million or so that we would otherwise have retained had we not pushed those rates through. But ultimately as a cost plus model we need to make sure we're pricing appropriately.

I think in terms of the number of people in that bucket, there's around 50% of our members that have had a 20% plus increase. To put that into perspective for you, in 2022 that number was 7.6% of our book. A massive shift in people getting that higher rate increase and for many of them it's been a compounding increase. I would say as we look towards the tail end of this quarter and into Q1 of 2025, that number in that upper bucket is starting to reduce which would give me confidence that as we move back into what is more of a traditional renewal cycle of under 20% increase, we would see our retention rate improve with that. We've been through a lot over the last couple of years. The members have stuck with us. I think it's testament to the value that we create for them when we provide them. As the average size increase drops to 15% versus 25%, I'd expect retention to improve with it.

**Josh Shanker**

I'm not trying to force you to give me a number but from what I understand it seems to be you're saying that about 50% saw the 20% rate increase this quarter that would be marginally less in 4Q and then 1Q after we might be here at the peak of the most amount of people getting the biggest increase?

**Margi Tooth**

That's absolutely right, yes.

**Josh Shanker**

Okay, thank you. That's very good clarifying. Appreciate it as well.

**Margi Tooth**

Thank you.

**Operator**

Our next question today comes from Jon Block at Stiefel. Please go ahead.

**Jon Block**

Great, thanks guys. Good afternoon. Maybe I'll start. I think it was the other North American products had 6,400 gross ads and in the slides it still shows not at scale yet. Margi, maybe you can just help me. What's the variable to help you with the returns? I think the retention rate there is 95% and change. That's got to get to 97%, 98%. The PACS 158. Does that need to go down to 125 or 130? What's the key there to help you get those suite of products off the returns and into the 30% to 40% IRR guardrails? If you're willing to tell us the timing behind obtaining it, that would be great and then I'll have a follow-up.

**Margi Tooth**

Yes, sure. Hi, Jon. When we think about the other North American subscription products, you hit the nail on the head. First of all, we've got to make sure that we've got the retention rate. We deliberately kept anchoring back that PAC investment so we could actually see how good is that member experience. It's obviously very different for all of those different products than the core Trupanion product. Really learning how to build on a retention rate that doesn't lean into the vet channel and necessarily high use of that product.

Similarly, as we look at pet acquisition, each of them are different channels, different distribution outlets for us. Leaning into how do we acquire those pets efficiently? How do we do what many of our competitors do in the direct consumer space efficiently? We're still learning how to do it. I will tell you though, as we've seen margin compression, we've really pulled back our spend in those areas, as you can see. Much less spend in Q3 than we had say a year ago in these products as we're really looking at taking the margin that we have and reinvesting it where we get the highest rates of return, which today is in our core Trupanion products.

Taking a little bit longer because of the margin compression to really pull those levers from a growth perspective with the other products. That being said, it gives us options and choices and we're making some nice progress, but I don't anticipate seeing them ramp up in the next quarter or two as we really get to grips with the core Trupanion growth instead.

**Jon Block**

Got it. That was very helpful. Thank you. Then just maybe the second question. For the quarter, it just depends on how you look at gross ads, but I've got your gross ads down modestly and that was down off a mid-single-digit comp. I think it's one of the first times you were down off a negative comp and I get it. You guys have been somewhat more passive and you wanted to wait until the pricing was back before hitting the gas, but now the MLR is back, right? It's intact. How do you think you fared versus market maybe over the past, I don't know, six to 12 months?

More importantly, the question I get is why would it take 12 months for you to ramp back up? It seems like you're buying yourself a little bit of time and saying, hey, don't expect a whole lot until, I don't know, I mean, are you even insinuating late '25? You've got the MLR back at 71, your capital requirements are not under duress. Why would it take almost a year until we start to see that really work its way through the gross ad number? Thank you.

### **Margi Tooth**

Yes, so this is the first quarter we've seen our pet acquisition spend grow after six quarters of it being flat or down, frankly, year-over-year. It's the first time we've really pushed more aggressively into pet acceleration. I will say that typically as a team that has historically been focused on growth, when you pivot that team from being in a pretty much a defensive position to an offensive position, you're going to start to see some changes in how they deploy incremental pack dollars. I'll tell you that execution is, as always, a challenge for any business. I think when you're growing quickly, making sure we're leaning into how do you take those incremental pack dollars and invest them wisely, invest them in the right areas at the right time. This is the first quarter, I'm really pleased that we're in a position now to take that as a tailwind and start to push in with more adjusted operating income spend.

To your point, we have a lot of runway ahead of us with both our capital and the adjusted operating income that we're generating. We will start to be more aggressive. I don't know if it will take a full year, but the example I gave a little earlier is when we think about how long it took for that PAC spend to really decelerate, there is an expectation it will take a little bit of time for it to accelerate as we put the foot on the gas there. We're definitely deploying more. We'll continue to be more aggressive with that PAC spend.

The first quarter in, we were being incredibly measured with how we were deploying and where we were deploying, making sure we can understand what the impact of those incremental dollars are. As we go into the rest of this year and into 2025, we expect that number to get bigger in terms of acquisition spend because we can. With that, I anticipate the pack count to come.

### **Operator**

Thank you. Our next question today comes from Katie Sakys with Autonomous Research. Please go ahead.

### **Katie Sakys**

Hi. Thank you. Good afternoon. I wanted to circle back first to the timing on growth, and maybe I'll ask it a little bit differently. I think at the September Investor Day, Margi, you had mentioned expectations to see the total pets enrolled number hit an inflection point at the beginning of 2025 and begin to grow again. I'm just curious, it sounds like maybe that's not exactly the expectation anymore. What has changed in the last month and a half, two months to shift your view there?

### **Margi Tooth**

I wouldn't say the view has shifted, and perhaps it's characterization of the September meeting. But definitely for us, we're learning how to redeploy some of the pet spend. Just to kind of put that into more context, when we think about what the team has been doing for the last 18 months, they've been adding pets, but not at the pace that Trupanion is typically used to adding pets. They've gone into quite a defensive mode in terms of how they're operating, how they're thinking about content, and how they're deploying PAC dollars. Typically, we would have a combination of investment across the whole gamut of tactics and initiatives across the marketing suite of things. Whether that's display, advertising, whether it's above the line, whether it's in-person events, you name it, we did it.

As we pulled all of that back, it takes a while to build that brand back up in the market. What we're learning is the efficacy of the brand in 2023, as we started to peel back and pare down that PAC spend, it took a long time for that really to wear down, which is great. That's also off the back of 36 consecutive quarters of increased pet acquisition spend. When you turn that back off, I'm anticipating it will take some time to build back up. We're going to do it in a measured way, and Q3 was the first quarter we were able to be a little more aggressive with our spending. We hit that 36% IRR. I think the team did a very good job of managing that. As we see the margin continue and get those results for Q3, we're very happy with that 71%. That's been a lot of hard work, and that AOI increase is huge for us. It gives us a tailwind to be a little bit more boisterous, if you will, with our pet acquisition spend in Q4 and also, frankly, in 2025.

It's not going to happen overnight because we're always deploying within those guardrails, and that is not easy. Growth at this level is not something that you can just flick a switch and get turned on, but definitely from a brand building point of view, I'd expect to see the compounding effect of that increased investment payoff into 2025.

**Katie Sakys**

Okay, fair enough. Then maybe touching on ARPU, congrats to you guys. It's definitely ticked up quite a bit this quarter. That 13%, is that something that we can expect to continue to see going into 2025 as we put numbers into our models?

**Fawwad Qureshi**

Yes, I think a couple things I could say on that. As I stated earlier, of course, pricing has played the biggest role in terms of sources of revenue this year, and some of that pricing is going to continue through next year. I think our expectation is ARPU accelerates in Q4, and based on the trends and the expectations we've seen from a forecasting standpoint, so I think you'll see more contribution from ARPU. I think, again, not to talk about 2025 in detail, but our expectation would be that both pricing and pet count would be contributors, and I feel good that you'll get the tailwind from pricing increases continuing to go through, provided that we can continue to be disciplined about retention. Then there's the potential, as Margi talked about, of re-accelerating investment and growth, and we feel good from a financial and overall capitalization standpoint that we have the ability, we have the financial wherewithal to do that. That's what we're thinking about.

**Operator**

Thank you. Our next question today comes from Wilma Burdis with Raymond James. Please go ahead.

**Wilma Burdis**

Hey, good afternoon, everyone. Were there any one-time benefits in the loss ratio in the quarter in subscription?

**Fawwad Qureshi**

Yes. Hi, Wilma. In Q3, yes, we did see a one-time benefit of about \$500,000, so think of it as 20 basis points of improvement. Just so you have the comparison, so in Q2, I talked about a \$2.1 million benefit, and that was about 100 basis points of improvement.

**Wilma Burdis**

Okay. Thank you. Then could you just talk a little bit about this core subscription loss ratio came down or improved quite a bit quarter-over-quarter, and then the other business moved the opposite direction. I understand the other business is a flat margin, but maybe just talk to us a little bit about the pieces there. Thanks.

**Fawwad Qureshi**

Sure. Obviously, I'll start with the subscription. Obviously, we've been pleased with the performance in the quarter. We're happy to have achieved a 71% quarter early. I think as we talked about, the overall performance is seems largely tied to performance in July. We saw lower overall frequency, and then that trend abated somewhat as we went through the quarter, so that was the biggest factor in terms of improvement.

I think the other piece that we haven't talked about is continuing to drive claims expense processing down. This is something actually the Company has been working on over the last couple of years and just driving efficiency there, so that's been a bright spot as well. Part of that is the benefit of technology, so having completed or largely completed the transition to the Vision Claims platform, that's been a contributor to higher productivity.

Shifting to the other business, so the loss ratio did increase. It was 71.2% last quarter. It went up again to 76.1%. Pets Best, similar to what we've experienced, is seeing inflation and putting pricing through. In this case, we had a favorable reserve development in Q2, similar to what I talked about in the subscription business. Of course, for us, as you recall, any changes to loss ratio, including any impacts to reserving, they don't influence the margin we earn on the business because, of course, the agreement is loss sensitive. If loss ratio improves, as it did last quarter, they participate in the upside. If loss ratio worsens, they experience the downside.

From an AOI standpoint, I spoke in Q1 when AOM was about 1.6%, that we would largely be in that range going forward. We're 1.6% in Q1. We were 1.7% last quarter. We were again 1.7% this quarter.

**Operator**

Thank you. This concludes today's question-and-answer session and today's conference call. We thank you all for attending today's presentation. You may now disconnect your lines. Have a wonderful evening.