



Trupanion, Inc.

Fourth Quarter 2021 Earnings Call

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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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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

John Barnidge, *Piper Sandler*

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Jon Block, *Stifel*

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

Operator

Greetings, and welcome to the Trupanion, Inc. Fourth Quarter 2021 Earnings Conference Call.

At this time, all participants are in a listen-only mode.

I would now like to turn the conference over to your host, Laura Bainbridge, Investor Relations.

Laura Bainbridge

Good afternoon, and welcome to Trupanion's fourth quarter and 2021 financial results conference call.

Participating on today's call are Darryl Rawlings, Chief Executive Officer; and Drew Wolff, Chief Financial Officer. Similar to prior earning calls, Margi Tooth and Tricia Plouf, will be available for the Q&A portion of today's call.

Before we begin, I would like to remind everyone that during today's conference call, we will make certain forward-looking statements regarding the future operations, opportunities, and financial performances of Trupanion within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995.

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 our earnings release, which can be found on our Investor Relations website, as well as the Company's most recent reports on Forms 10-K 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, fixed expenses, variable 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.

Unless otherwise noted, margins and expenses will be presented on a non-GAAP basis, which excludes 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 call is also available via webcast on Trupanion's Investor Relations website. A replay will also be available on the site.

With that, I will hand the call over to Darryl.

Darryl Rawlings

Thanks, Laura.

Twenty-twenty-one wraps up the first 12 months of our 60-month plan. By all accounts it was a strong year for Trupanion. Total revenue increased 39% to \$699 million. We ended the year with over 1.1 million total enrolled pets. Within our subscription business across multiple brands, we had over 704,000 pets at year-end, on average staying with us 79 months. Lifetime value of a pet was \$717 up 10% year-over-year. Our gap to TruTopia which measures the difference between members adding pets or referring friends and pets turning off was 0.29, a 17-basis point improvement over 2020.

I am extremely proud of this performance, but what I'm most focused on is the growth in our adjusted operating income. Adjusted operating income represents the funds generated from our existing pets in a given period and is the single most important metric to understanding and evaluating our performance. It also serves as a proxy for value creation.

In 2021, adjusted operating income grew 37% over the prior year. This performance is exceptional and well ahead of our 25% target we laid out in our 60-month plan. Our outperformance was a result of us doing three things really well: accelerating pet growth, sustaining high levels of retention and maintaining scale within our subscription business. In short, the team fired on all cylinders.

Within our large and underpenetrated market, we want to deploy as much of our adjusted operating income within our targeted internal rates of return as possible. As we grow and scale, we're seeing more opportunities and the team is doing a great job putting our capital to work against them.

In 2021, we were able to deploy 56% more capital year-over-year at an estimated internal rate of return of 36%. We do this while operating at scale. In fact, Q4 marks the fourth quarter in the last eight, where we were within 100 basis points of our 15% adjusted operating margin target for our subscription business. I know we'll not hit 15% every quarter as we did in Q4. But I am encouraged by the narrowing of the range around our target. To me, in light of all the talk around inflation, it shows very strong execution. Well done, Team.

Hitting scale, or the size in which we operate efficiently while maintaining our margin targets, is hard and takes discipline. Doing so has taken us over 20 years. As we move forward, and we do so with a commitment to remaining the industry's low-cost operator and to reinvesting any future cost efficiencies back into the value proposition we offer to pet owners. I outlined our plans to do so further in our 60-month plan. Our 60-month plan can be found in our most recent shareholder letter on our IR website.

One great benefit of being a low-cost operator and building the Trupanion brand into what it is today is that we attract the interest of potential new strategic partners and distribution channels. We're humbled and excited when we can find partners who are leaders in their field, have long term alignment and recognize the value of our brand, scale and expertise. State Farm, Aflac and our most recent partnership with Chewy are perfect examples.

Later this quarter, our Aflac powered by Trupanion employee benefits product will be made available to select Aflac brokers to begin selling this new insurance offering to work sites across North America. We are excited to grow this channel through our strategic alliance with Aflac, a partnership which increases our reach and is a key component of our 60-month plan.

In short, 2021 was an exceptionally strong year overall. We came out of the gates flying but saw growth slow in the fourth quarter. In Q4, we enrolled approximately 4,000 fewer pets than in Q3. We believe this was driven by the introduction of the Delta and Omicron variants providing some industry challenges. So far this quarter, we're seeing activity rebound to Q3 levels. Results under Margie and Tricia's leadership have been humbling to say the least. Years such as 2021 are not the standard by which we measure our success.

I'll reiterate, our goal remains to grow adjusted operating income by 25% every year for the remaining 48 months of our 60-month plan. We believe this is the right target for our large, underpenetrated market. As we work towards our 60-month plan, we want to ensure we remain organized in a way that is most effective. Ultimately, we're a growth company, and we continue to align the organization to provide clarity of the direction around this mandate.

As part of this, Tricia recently assumed the role of Chief Operating Officer and Margie has remained President, responsible for leading the execution of our 60-month plan. While much of the day-to-day responsibilities remain the same, I expect these changes to drive greater clarity, transparency, and accountability within our organization.

With that, I'll hand the call over to Drew.

Drew Wolff

Thanks, Darryl.

I will focus the majority of my commentary today on our fourth quarter results. I will also provide some framework for outlook for both 2022, as well as our 60-month plan. Before I do so, I want to provide a few observations on our 2021 performance.

It was another fantastic year of growth. With the strategic investment from our long-term partner, Aflac, 2021 marks the first full year we weren't limited by our operating cash flow guardrails. Instead, we were able to invest for returns, deploying more capital at our strong internal rates of return, and as a result, drive significant value creation for our shareholders. It also meant we could invest in expanding our total addressable market by adding new products and geographies, including those that are set to launch this year. In short, it was a strong year, and it has been a privilege to join this Company and be a part of its incredible growth over the past year.

Turning to our fourth quarter results, total revenue was \$194.4 million, up 36% year-over-year. Our performance was led by strong pet additions and sustained high levels of monthly retention in our subscription business, as well as continued growth in our other business.

Within our subscription business segment, revenue was \$134.1 million, up 26% over last year. Excluding the impact of foreign exchange, subscription revenue would have been \$134.4 million in the quarter. Total enrolled subscription pets increased 22% year-over-year to approximately 704,000 pets as of December 31.

Average monthly retention, which is calculated on a trailing 12-month basis, was 98.74% compared to 98.71% in the prior year period. We saw year-over-year improvement across all three categories that we measure. We're especially pleased with the improvement in first year retention given our accelerated growth. Continued expansion in this metric means we're able to invest more into our growth and target the highest sustainable lifetime values in the industry. As the size of our pet portfolio grows, so too does the value created from our high retention rates.

Monthly average revenue per pet was \$63.89, an increase of 3% year-over-year and growing ahead of our cost of veterinary invoices, which increased 1.9% over the same time period. Now that we are operating within a reasonable range of our target margin, we are focused on competing and winning with the highest value proposition in the industry. That means pricing accurately to our 71% value proposition across our subcategories, including increasing or decreasing prices as necessary. For example, in the fourth quarter, we reduced price for 16% of pets in our portfolio. Year-over-year growth in ARPU reflects this dynamic as well as our broadened distribution.

Similar to past quarters, we saw the strongest net pet growth in areas where we were most accurately priced to our 71% target. This will continue to be an area of focus, particularly in light of the growing conversation on inflation in veterinary medicine, and the need for veterinarians to raise pricing.

As a percentage of subscription revenue, variable expenses increased slightly over the last year to 10% of revenue, reflecting investments in our member experience. Fixed expenses were consistent with last year at 5% of revenue.

After the cost of veterinary invoices, variable expenses and fixed expenses, we calculate our adjusted operating income. As noted, our subscription adjusted operating margin was 15%, hitting our target. It's encouraging to me to hit our target margin on the back of a 3% increase in ARPU in the quarter. Once again, it highlights our cost-plus approach and ARPU as an output of pricing to our 71% value proposition.

In dollars, our subscription business delivered adjusted operating income of \$20.3 million, an increase of 30% over the prior year period. It's worth reiterating that the vast majority of Trupanion's intrinsic value is derived from our core subscription business, which is highly recurring and enables us to accurately forecast. In the quarter, our subscription business accounted for 91% of our total adjusted operating income.

Now I'll turn briefly to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and different margin profiles than our subscription business. Total Revenue was \$60.3 million. Compared to the prior year quarter, this is an increase of 66% year-over-year, reflecting an increase in pets enrolled within the segment and the one-time effect of adding revenue from our software acquisition at the end of 2020.

Adjusted operating income for the segment was approximately \$2.1 million. While lower margin, our other business provides scale and data and fixed expenses and we incur virtually no acquisition spend.

As a result, our total adjusted operating income was up 35% over the prior year period to \$22.4 million. During the quarter we invested \$17.6 million or 28% more year-over-year to acquire approximately 54,000 new subscription pets. Gross pet ads were up year-over-year but down sequentially due to COVID temporarily depressing industry leads, which is recovering. This resulted in a pet acquisition cost of \$306, an estimated 32% internal rate of return for a single average pet.

We also invested \$0.9 million in the quarter and approximately \$4 million for the full year 2021 on development costs. These are primarily related to product and international expansion, which we expect to deepen our competitive moats. This resulted in an Adjusted EBITDA of \$3.5 million compared to \$2.2 million in the prior year quarter.

Depreciation and amortization was \$2.8 million, an increase of \$0.5 million year-over-year. This increase was primarily due to the amortization of assets from our software acquisition in the fourth quarter of 2020. As a reminder, this strategic software acquisition was aimed at improving our back-end processes, adding new products, geographies and talent.

Total stock-based compensation was \$6.8 million. As a result, net loss was \$7 million or a loss of \$0.17 per basic and diluted share compared to a net loss of \$3.5 million or a loss of \$0.09 per basic and diluted share in the prior year period. On a year-over-year basis the increased stock-based compensation impacted net loss by \$0.10 and the increased depreciation and amortization impacted net loss by \$0.01.

Turning to our balance sheet, we ended the year with over \$213 million in cash, cash equivalents and short-term investments and no debt. In terms of cash flow, operating cash flow for the year ended December 31, 2021 was \$7.5 million compared to \$21.5 million in 2020.

Capital expenditures totalled \$12.4 million in 2021, and as a result, free cash flow in the year was a negative \$4.9 million. At Trupanion, we are focused on the long-term and specifically our 60-month plan. We offer a high degree of transparency into our financial metrics and how we model the business.

Turning to our guidance, as we enter the new year, we're evolving the way we talk about our outlook. We want to take the opportunity to provide you with the forward-looking information that we believe is best aligned with how we run and manage our business. With this in mind, and consistent with our 60-month plan, we want to increase our intrinsic value per share by 25% per year, driven by growth in adjusted operating income.

In 2022, we have a high degree of confidence in our ability to hit 25% growth in subscription adjusted operating income. Within our other business segment, we expect adjusted operating income in 2022 to

remain largely flat, as we've made the strategic decision to not grow revenue from our software business acquired in Q4 of last year.

With this large and under penetrated market, we plan to continue deploying as much of our adjusted operating income as we are able to, within our IRR guardrails of 30% to 40%. As always, we will publish our IRR metrics and the individual components so that these returns can be validated and tracked over time.

Over the next 12 months, we'll be ramping up several of the initiatives in our 60-month plan that, if successful, would begin to manifest in our results in the second half of 2022 but more meaningfully so in 2023. These pre-revenue initiatives are reflected in development expense and we continue to expect them to run at about the 0.5% of revenue.

As a reminder, we view revenue growth and profitability as strategically linked. In periods of accelerated growth, you can expect reduced profitability due to the timing of cash flows, and the value being added is not represented by the profit in a particular period. Likewise, if we grow slower, our profitability metrics will increase.

We view this trade-off worth making for long-term value creation. We're well positioned in a large, underpenetrated market and have proven our success in this industry quarter after quarter. This, combined with the expectation that the cost of veterinary care will continue to rise, provides a long runway for Trupanion growth.

We have a strong track record to build from. In fact, by our calculation, Trupanion is the only company in the S&P 600 to deliver revenue growth in excess of 20% per year for every year over the past decade. We look forward to keeping you apprised of our progress.

With that, I'll hand it back over to Darryl.

Darryl Rawlings

Thanks, Drew.

Before we open it up for Q&A, I want to highlight our upcoming investor outreach activity. In the coming weeks we'll be participating in the Raymond James Annual Growth Conference. William Blair's VMX Q&A, as well as several non-deal road shows. For those of you who are new to the story, these are good opportunities to learn more. For those looking to do a deeper dive into our business, I'll point your attention to our two marquee investor facing events that will take place in 2022.

First, on April 30, Margie, Trish and I will be hosting our annual Q&A to follow the Berkshire Hathaway Annual Shareholder Meeting in Omaha. Over the years, we have found this to be a great event to connect with likeminded investors in an informal "any question goes" type environment. We're planning for an in-person participation this year in Omaha.

Second, on June 8, we will be hosting our annual shareholder meeting in-person at our Seattle headquarters. Our annual shareholder meeting is the venue to provide updates on the initiatives in our 60-month plan and to connect with leaders of the business, including Margie and Trish. We are optimistic that this year will allow for in-person attendance. We intend to design the event around the live experience. Those looking for opportunities to engage in Q&A and connect real time with the team are encouraged to travel to Seattle. We hope to see you there.

With that, we'll open the call up for questions.

Operator

The first question is from John Barnidge with Piper Sandler. Please go ahead.

John Barnidge

Thank you for the opportunity.

Vet service inflation was 5.1% in January CPI. Can you talk about the spread between vet invoice increases and then price increases? I think you talked about it last quarter as well, and then your outlook for that in 2022?

Tricia Plouf

Hi, John, this is Tricia.

I'll start your question and I'm sure others may want to add a little bit of color because there's multiple facets to it. In general, when we think about our pricing, it's based on what we're seeing come through in our invoices and targeting that 71% value proposition, so that's what's driving our rates and we're staying on top of it very frequently. For the total year, we saw the cost of our vet invoices at about 4.6% increase, and our pricing for the full year was a 5.3% increase. Now, that did soften a little bit, as you can see, in the fourth quarter, where we saw about 1.9% cost of that invoices coming through to us and our pricing was about 3%.

What we're trying to do is stay ahead of it, stay on top of it, but at a very granular level. You heard on the call, we actually decreased prices in some areas where we needed to do that to get closer to our 71% value proposition. But there are some cities, like one example is Palm Springs, where we saw 13% cost of goods in vet invoices coming through and then others were lower. The point is, we're looking at it on a very granular basis and we're targeting the 71%.

You mentioned January, we've been looking at our January data that we're seeing coming through. I would say so far we are not seeing much of a different trend than we've seen the past couple of quarters. But early February data, and I would say it's very early so we're still looking at it, does start to see a tick up. We'll be monitoring that not only in totality, but at a very granular neighbourhood level to make sure we can stay on top of it, we can get the pricing through that we need.

The good news is I think we're doing a good job in terms of, as you can see from our results, targeting that 71% better, hitting it more consistently, not only overall but on a granular level. We're just going to stay focused on that and have that really, really drive how we're operating.

Drew, do you want to comment more on what we're looking at going forward financially?

Drew Wolff

Yes.

I'll just emphasize what Tricia is saying is, we're seeing—we're pricing for increases. Now, that's mathed a little bit by us refining our pricing and actually decreasing price on part of our portfolio. Also, in prior quarters, we've mentioned a change in mix. As we broaden distribution, we're growing in lower cost areas and you see that come through our pricing. But looking forward, we don't see—based on what we know

now, we don't see those trends changing. But if we do, we'll continue to—as we've shown, we'll continue to price for it.

Margi Tooth

John, if I can, it's Margi.

If I can just add to this. In terms of Trupanion overall, we believe the vets do need to increase their rates. We believe that they're currently under-priced for all the services that they offer. They are a highly stressed, vet (inaudible) in the industry. The best thing they can do is to make sure that they're pricing appropriately. We, as Tricia and Drew both mentioned, are looking at our pricing at a very granular level. We feel confident we can stay on top of that, but for the good of the industry, and also to increase demand for Trupanion, it's better that they increase the rate because they need to.

John Barnidge

Okay. Then maybe my follow up question. I believe adjusted operating income is now the guidance you're talking about. I didn't hear anything on revenue. Can you maybe talk about that shift and maybe how the new partnerships you're launching with Chewy and Aflac fit within that shift?

Drew Wolff

Sure, this is Drew.

Yes. What we've done is evolve our approach, consistent with how we've given long-term guidance in the 60-month plan, and then specifically for 2022, to focus on a bottom-line metric, like adjusted operating income, because that's what we manage to. As we rollout initiatives, we are targeting similar margins in adjusted operating income. That's why we thought it was a better way to guide to. Then with consistent margins now that we're at scale, you can back into other metrics and the IRRs that we're targeting.

We're just evolving from starting at the top line and going down, to starting at the bottom line and going up. But embedded in our guidance is all the initiatives that we've already talked about, as that will ramp up slowly during the year and then more meaningfully impact 2023.

Tricia Plouf

This is Tricia.

I'll just add a little more here because we know this is a bit of a shift and an evolution. In general, we have always provided a lot of transparency, whether it's on the calls or the shareholder letters and we don't intend for our philosophy around transparency to change. But we also want to make sure we're speaking in a way that is very consistent with how we're looking at the business, running the business, metrics that we're targeting as we have more products and more geographies.

As Drew mentioned, by honing in on the adjusted operating income and our target margins, which we're very close to achieving, can really back into the 25% then on, overall, on the top line, as well. I think these new initiatives, while they haven't—many of them have not launched yet, we don't have great visibility into them, they'll ramp up likely slowly as the year goes on.

Longer term, they give us more and more confidence that our 25% growth rate that we've talked about in the 60-month plan is achievable because that level of growth year after year is not—while we've done it

for a long time, it's not easy. It takes good execution and we're focused on that. Hopefully that helps just add a little bit of color to how we're thinking about it.

John Barnidge

It does. Thank you.

Operator

Thank you. The next question is from Shweta Khajuria with Evercore ISI. Please go ahead.

Shweta Khajuria

Okay. Thank you.

Let me try two, please. Chewy partnership, possible to please provide some context on how we should think about framing that opportunity, basically the meaning and magnitude of that opportunity, as you think about this year and just next 48 months?

Then the second question is on marketing environment. Could you please provide some context on what you saw, just generally, in terms of the marketing environment, whether it was a crowded market, and in particular, were there any channels that worked really well for you, and/or were there some channels that were a disappointment to a negative surprise, and which ones were those? Then same question for Q1, now that we are off the holiday season, what's the marketing environment looking like right now? Thank you.

Darryl Rawlings

Shweta, you kept layering on questions there at the end, but I'm going to answer...

Shweta Khajuria

Sorry, Darryl. Answer (inaudible).

Darryl Rawlings

That's okay. I'll hand over all the details to Margi.

But when we're thinking about bringing on new partnerships, new distribution channels, new products, expanding geography, all of the things that we're looking at comes down to a single focus. How is it that we can inform and educate pet owners or households when they get a new pet to the household? All of our partnerships are meant to be a way for us to initiate conversations from people that have strong authority, being veterinarians or breeders or Chewy as an online retailer or Aflac for worksite benefits, etc. It's really about us being at the front of the lead generation and educating consumers on why it's important to have high quality medical insurance to help them budget. That's the lens that we're looking for. That's a lot of it is in the 60-month plan. But I'll hand it over to Margi to give you more details.

Margi Tooth

Yes, hi, Shweta.

Just to finish off on the Chewy partnership, obviously we're very excited to be and honestly humbled to be their partner. In terms of the magnitude for 2022, we're going to start off fairly slowly and controlled throughout the beginning through midpoint of the year. Then throughout the year we will grow and expand that at a pace that we feel comfortable with together. We are well aligned partner with them. I think we have some great opportunity in front of us, to Darryl's point, it's a great opportunity to start to connect with people in an online environment that have the partnership and support of a fantastic brand in Chewy.

In terms of the marketing environment, your second question, there are a couple of questions in there. What are we seeing in the quarter in Q4? A couple of things happened. We went into the quarter pretty aggressively with our spend and we had a solid start in terms of the lead volume. The lead volume was up, it's been continuing to be up throughout the year last year. Started to slow a little bit. We saw a pocket of Omicron and really the pandemic started to hit, as the world saw, at the back-end of that quarter.

We saw that coming, we saw it happening. We saw the softening. We made a very deliberate decision, unlike at the beginning of the pandemic when we weren't really sure what was going to happen. We didn't really continue to be aggressive with our spend in a space to really help drive through the pandemic that we saw happening, and also to give us a really good start to the year in 2022.

In terms of channels, we saw a very similar trend across all of our channels. There wasn't one that was performing particularly badly, wasn't one that was performing particularly well. I will say that there was a challenge we had in terms of conversion, which we noticed in terms of execution through the quarter. We were able to rectify that. We spotted the problem. Execution, we've always said, is challenging. It's great when we can identify where there are issues and we can fix them. I'm happy to say we have fixed them. Moving into Q1, we're back up to the levels that we saw in Q3 in terms of growth rate and seeing that overall starting to sharpen up nicely. I think positive end to the quarter and really strong start to Q1 as well.

Shweta Khajuria

Okay. Thanks, Darryl. Thanks, Margi.

Margi Tooth

Thank you.

Operator

Thank you. The next question is from Jon Block with Stifel. Please go ahead.

Jon Block

Hey, guys. Thanks, and good afternoon.

Maybe the first one is just to start the gross adds. I think they were down Q-over-Q for the first time since the fourth quarter of 2019, and I get it, you talked about a specific COVID headwind. But do you have a way of quantifying what that was when we think about the impact to gross adds? I don't know, 4,000 or 5,000, if you want to throw a number out there. Then how do we think about that coming back into the Q? In other words, does it all come back in 1Q '22? You mentioned a good start to the year and then it normalizes? I'm just trying to think about that cadence of gross adds, which stepped down in 4Q, how we think about it starting the year in 2022 and then subsequently in the quarters after?

Margi Tooth

Yes, Hi, John. It's Margi.

I'll kick off and obviously others can add. In terms of, you are right, 4,000 was about what we thought was the difference between what we were anticipating and the impact of the COVID headwind. In terms of recovery, we've seen since the midpoint of January, we started to see that really come back. One of the key things that we look at when we're going into any month, we don't typically think about it quarter-over-quarter, we're thinking on a monthly basis, especially in times of pandemic when you've got such a variability. We look at the overall market opportunity for us in a given period of time.

We use Google data; we use all the data that's available to us. We can see how many people are searching for the term pet insurance. They're people we believe to be in market. People don't typically look for pet insurance unless they are in market at the time. What we found is at the beginning of the pandemic back in 2020, so March, April 2020, the volume of people searching really came down. That was a time when, I'm sure you remember, we doubled down, we focused on what we could control, which is our member experience. We really started to pull back on our spend because we weren't sure where it was going to go.

When we hit similar periods, so in Q4 we were looking at the same search volume which had recovered since Q1 and Q2 of 2020, it dipped to the same levels as the beginning of the pandemic. For us, that told us that the market was a lot softer than it had been. We made a very conscious decision to push hard and we wanted to push hard to add aggressively, not only so we could keep our brand front of mind from a pet owner and veterinarian perspective, but also because we were confident it was going to return.

We also have immense confidence in the team's ability to turn levers on and off as we need to. We've got really sharp at doing that. As a result of that, we've seen some really good growth coming in, as I mentioned at the top half of the year so far, top part of the year. We're happy with the lead volume. We're happy with conversion rate. We've corrected some issues we had from an execution point of view. I'm sure there will be other issues that we will have from an execution point of view, but right now I feel confident in where we're going and seeing that momentum come back up to the levels that we would expect it to be at. I think overall happy with the February performance so far.

Darryl, anything to add?

Darryl Rawlings

Just context, Q4 of '21, we grew net pet new growth 11% over a huge comp of Q4 of 2020 and all of that with the challenges in the marketplace that have rebounded. I think the team did great and looking forward to seeing 2020 play out.

Jon Block

Okay. That's helpful. Thanks for the colour.

The second question might have a couple of different parts to it. Maybe the most straightforward, just on the Chewy partnership, how that's structured? In other words, is there an equity component when we think about the compensation going to Chewy from a pack perspective? Again, is there an equity component tied to that?

Then just backing up for a second, guys, I'm a little inundated with emails saying questions around the guidance. Can you just help me out here for a second? You were very clear that the adjusted operating

income of 25% of subscription, flat on other; did you commit to an adjusted IRR number? Is that still expected to be 30% to 40%?

Then, maybe just with all due respect, you were just talking about how you're one of the few companies in the S&P 600 to have this revenue growth rate and you're a rare breed. The most straightforward number is a revenue number, not an adjusted operating income number. Can you just maybe better explain why at this point in time you've decided to back away from providing the revenue number? Thank you.

Darryl Rawlings

Well, the first question was about Chewy. We think we've got great alignment. As a reminder, it's meant to run on the same type of margins and the same type of internal rates of return as our core subscription business. We had mentioned earlier that Chewy would have the option of taking some of that when otherwise would be tax spend in stock if they choose up to a certain cap. We think we've got great long-term alignment.

Your other areas of questions, why are we talking about adjusted operating income? Because adjusted operating income is more meaningful to shareholders when they understand the cash flow of our business. If our margins are relatively stable, it's very easy for somebody to do the math to figure out what the impact of revenue is. Lot of companies can give revenue guidance but without giving guidance down to a contribution margin or the margins that you are able to spend, it doesn't give investors as much opportunity. The other part is internal rates of return, and we are committed to staying between our guardrails of 30% to 40%.

Jon Block

Perfect. Thank you.

Operator

Thank you. The next question is from Maria Ripps with Canaccord. Please go ahead.

Maria Ripps

Great. Thanks for taking my questions.

I just wanted to follow up on the Chewy partnership and just maybe expanding on some of Shweta's questions. If we look at their customer base of about 20 million, do you have a sense of what portion of that could be a more needed addressable opportunity for you here in the near term? Anything maybe you can share around the pet base by age, et cetera?

What would you consider to be a successful outcome here, let's say, four, five years from now in terms of a mix of two customers taking on one of these plans? Just trying to understand if this partnership could potentially accelerate adoption of pet insurance across the space.

Margi Tooth

Yes, sure. Hi Maria, it's Margi here.

In terms of Chewy's 20 million base, the point that is really critical for us is they are partner that we are—we're working with to help educate and inform pet owners about the benefits of having high quality medical insurance. In terms of what is our immediate addressable opportunity, we have reason to believe

that they don't have any more or less penetration rate than the average population. We don't know and that's the reality.

We're excited to work with them to bring to light something that we believe every pet owner should be aware of and every pet owner should have the information available to make a conscious decision on whether they are insuring their pet. That's something that Chewy is very eager to do as well.

I think for us, what we believe together is that we can help not only increase the awareness and education but ultimately adoption and drive more insured clients into the veterinary practice to get them the care they need. Successful outcome for us is honestly making sure that there is an increased awareness. We believe a 2% penetration. We're woefully underpenetrated, there's a lot of market to take. Together, we're hopeful that we can do that. The alignment that we have I think, as partners, is a good starting place but we'll be able to share more once we get into the market with product.

Maria Ripps

Got it, that's very helpful. Thank you, Margi.

Then secondly, can you maybe share any colour around your launches of PHI Direct and Furkin in Canada last year? Is there an updated timeline for the U.S. launch at this point?

Margi Tooth

Yes. Sure.

PHI and Furkin are now about six months in from the launch in the Canadian market. We're happy to see that overall in terms of the lead volume, we're looking really healthy. We're definitely reaching pet owners in the right way. The area that we're still continuing to focus on is to work on our conversion rates. We operate within the same IRR guardrails for PHI and Furkin as we do for the core subscription business for Trupanion product. For us, it's really a case of refining that conversion journey, making sure that we're not just paying for leads without converting them. When we get that to a level we feel comfortable with, within our 30% to 40%, that's when we will trigger and move into the U.S. market.

We're not going to do that without having the opportunity to really know we can refine the same levers for those two brands as we can with our core subscription business. The timeline is still to be determined but the teams are working hard on refining the process and looking forward to them coming to U.S. in hopefully in the not-too-distant future.

Maria Ripps

Got it. Thanks a lot for the color.

Operator

Thank you. The next question is from Elliot Wilbur with Raymond James. Please go ahead.

Elliot Wilbur

Thanks. Good afternoon.

First question, I want to ask about the upward trend in the variable cost of revenue within the subscription business. Obviously just relatively small increments but it keeps getting closer and closer to this 10%

level. I think it was 9.8% in the quarter and for the full year. Just trying to get a little bit better sense of what's driving that upward progression. Is it retention cost or is there something else in there? Is it possible to say that there is a ceiling on that or is there some level at which you think that metric is going to hold, or is there a possibility there we actually see this move above the 10% mark? That's first question.

Tricia Plouf

Sure, hi. This is Tricia.

Yes. We did see this variable expenses, which as a reminder, it's really the cost associated with servicing our members through customer care retention effort, particularly after the first year, and other strategic initiatives that are designed at our member experience. We did make a strategic decision early on in 2021 to invest more heavily here, particularly on retention initiatives to—that we had in mind to help improve our retention rates, which were very successful during the year as you can see from our retention metrics.

I would say, overall, I wouldn't expect it to go beyond 10%. We are looking, as with anything, to maintain the metrics that we've been able to drive, but scale them longer term because our ultimate goal is to be giving as much back to the member in terms of that invoice payment as possible. But this was a worthwhile investment that we continued throughout the year as we saw the results play out in retention.

Drew Wolff

This is Drew.

I'd add that the bigger our portfolio gets, each basis point of retention is worth more, so it was a good investment. Then I would also add that we're targeting at a 15% adjusted operating margin. In the quarter, even when it was at 10%, we delivered that. That's how we're running the business going forward.

Elliot Wilbur

Okay. Thanks.

Maybe just a little bit more of a macro question. Obviously, the relatively slow start to the year in terms of vet clinic visits and seeing some of the services suggesting numbers are down year-over-year. Just curious how that has impacted overall total lead volumes, whether or not there's been any impact on the conversion rates within your different lead channels?

Margi Tooth

Hi, it's Margi.

In terms of vet visits, the wellness visits that we saw being suppressed in the back half of '21, that's definitely rebounding. We're seeing vets, people having to make appointments, as I'm sure many of us recognize, some weeks and months out but they're happening. We're seeing the volume—lead volume is absolutely picking back up again across all of our channels, not just within vet, but vet obviously is the one that really drives the markets for us and for the industry.

In terms of conversion rates, conversion rates are also improving. I mentioned before that we've made some adjustments from the way we're managing conversions; spotted an opportunity there which we've now corrected so feel good about (inaudible). It doesn't mean that the work stops there. We've got a lot still to do but still happy about the momentum we have going into the rest of the quarter.

Elliot Wilbur

Okay. Just last question. With respect to your overall debt inflation levels out there, I'm not sure how much variation you're seeing by market but wondering if you're seeing any noticeable changes in terms of the buckets that you highlighted previously in terms of distribution and how pricing increases may in fact impact your business? Basically looking to see if maybe perhaps there's been a disproportionate increase in the pricing bucket with greater than 20% overall inflation?

Tricia Plouf

Yes. This is Tricia.

I would say, in general, like I mentioned, behind the scenes there is a relatively large variation in cost of care, prices coming through, utilization of care, and then also there's been some of the COVID impacts in certain areas more than others. We do see variability. Also, like I mentioned, we've had certain areas where we haven't been priced as accurately as we could have been. We pushed through decreases to get closer to our value proposition, which then should allow for more equal increases if an increase is needed in the future, as opposed to whipsawing people around.

In general, I would say I think we're getting better at not as many members needing to fall into the very large price increase bucket as we get more and more granular. That being said, as we're targeting that 71% value proposition at a neighborhood, breed, age and enrolment level, if we're seeing the information come through that necessitate that, we will push it through because that's the right thing to do at that granular level.

I think we're getting much, much better, particularly over the past year, with spending more resources on this. I would also say area is one of the reasons where we're really pushing to get better at this, whether there's an increase needed or a decrease needed, it's because we do see growth, messaging, everything comes together better in a particular area when we are more accurately priced and can have those smoother increases going forward.

Margi Tooth

Yes. I can add to that as well.

When we think about specific markets, to Tricia's point, we're looking across the whole business at a very granular level from end-to-end in that journey, from pricing to sale to retention and the whole member experience. There is no difference in the price point, if you look at it by dollar amount. The key thing is, as Tricia mentioned, the 71% and that value proposition is so critical.

The ability for our teams to sell our product and the people to appreciate the value is good and it doesn't make a difference what that price point is so long as the value is there in the product and people understand what they're getting. There isn't a price sensitivity, we don't see that shifting by market. It's all about making sure the product is doing what we set out to do in solving that problem. If we price accurately, we know it can do.

Darryl Rawlings

Yes. I'll add just one more bit of color.

We have one market, for example, that is double digit inflation. In that market, we've got a high percentage of hospitals that we're paying directly. That market is in the state of TruTopia, meaning referral and added pets are greater than cancels. In that market, over 40% of new enrolments are coming from referrals and the growth rate in that market is greater than 30% year-over-year and it's a mature market. When we have the value proposition right and we've got the right customer experience, we have a perpetual growth machine because we've got such low penetration rates and that's super exciting to see those things.

Hello?

Laura Bainbridge

We're ready for our next question.

Operator

Thank you. The next question is from Ryan Tunis with Autonomous Research. Please go ahead.

Ryan Tunis

Hi, thanks. Good evening.

First couple of questions on the Chewy deal. From an ARPU perspective, is that going to—is that expected to be more like the \$44 per month other pet or closer to the \$63 that we're seeing in subscription? That's one. Then also, in anticipation of the Chewy partnership launching in the spring, is there—should we assume you're going to hold back some pack spend potentially for the back half of the year? Thanks.

Margi Tooth

Hi Ryan, it's Margi.

I can kick off this. The Chewy products are designed exclusively for Chewy. The teams are refining some of the different value propositions—the overall product sets. There will be similar products in there but—excuse me, we'll be ready to share that more as we go closer to launch.

In terms of holding back pack spend, no, we're not—when we think about the way—the margins the way the business is changing, we are not holding back anything here. I think it's going to run similarly to how we would run any other part of the growth side of the business, and we're thinking about the core Trupanion products, we think about Aflac, Chewy, so we will run within the same IRR guardrails as we have been with the other products and the difference there.

Ryan Tunis

Got it. The reason I asked that question is when we start thinking about pretty big numbers from Chewy, that could seemingly cut into the profit margin that you have reserved for investment in new pets. Is that something you're worried about, you think you'll be able to meet that?

Drew Wolff

This is Drew.

Yes, we think that would be a good problem to have. We're investing for growth, we have a strong balance sheet and if the returns are there, we will invest the money.

Ryan Tunis

Got it. Then, my follow-up is just on the guidance you gave for adjusted operating income. Does that contemplate any contribution from Chewy or any of the aspects of the multi-year plan?

Drew Wolff

Yes. Embedded in that guidance is all the initiatives that we've teed up. It just gives us greater confidence around hitting 25% this year and also into our 60-month plan. As we mentioned, it will ramp up slowing during the year and really impact 2023.

Ryan Tunis

Thank you.

Operator

Thank you. The last question is from Greg Gibas with Northland Securities. Please go ahead.

Greg Gibas

Hey, thanks for taking the questions.

I think in your prepared comments you talked about (inaudible) the Aflac partnership beginning to target work sites across North America. I'm wondering if you could just expand on maybe the timeline of that deployment of the initiative there and when we might begin to see a financial impact from it.

Margi Tooth

Yes. Hi Greg. I'll pick up here, it's Margi.

In terms of the Aflac timing, so excited to be launching that with them this quarter. We are rolling out to a small number of select brokers initially, just, again, to make sure that we're controlled, that everything that we have built there is really effective and humming, and then we will slowly build on that through the rest of this year. We don't expect or anticipate any meaningful contribution in 2022.

As a reminder, the employee benefit space typically has two real tranches of enrolment periods, the first in July and the second in January. Launching at this point in time allows us to really build through that and make sure that we're all feeling confident. Aflac remains an incredibly well aligned partner. They are a shareholder of Trupanion's and that alignment there really does help make sure that we're checking all the boxes in the right way. They've helped hold our hand through the environments from work site perspective. We're running ahead of plan and we say it's gone very smoothly so far and we're excited to see where it goes.

Greg Gibas

Great, that's helpful, Margi.

Regarding, just a follow-up on the increased variable expenses relating to investments in the member experience that you talked about. Should we expect that be recurring or more one time in nature in Q4?

Margi Tooth

Yes. I would say that's our current run rate with the initiatives that we're seeing working well. Obviously, we don't want to stop doing those initiatives but anywhere that we can drive scale moving forward, we'll be hoping to do so.

Darryl Rawlings

I just want to reemphasize, in Q4, we hit our 15% target margin pretty much right on line. In the event that we get any additional savings, we are going to be planning on giving those savings back to the consumer and having better value proposition. For those modelling the business, what's most important to model is that 15% margin and the higher percentage we can give back to the consumer is only going to help retention rate, referral rates and our lifetime value of a pet which then allows us to spend more money to acquire pets.

We're not trying to get margin expansion from 15% to 16%. We said years ago that was our target. We said in our opening remarks that we've been narrowing around that four of the last eight quarters. In Q4, a time when people were concerned about inflation, we hit it perfectly. We balance between customer experience and paying hospitals directly 24/7 and trying to give as much back to the customer as we can.

Greg Gibas

Great. Helpful, Darryl.

If I could sneak in a last one, I noticed you didn't address your pet food offering. Any developments there along that initiative?

Darryl Rawlings

Still testing. We're excited about it. We think it could be a great initiative and the data that we have around our business we think can be very supportive. But we're still trying to fine tune things. We're not doing any product launches. We're not doing anything with consumers yet. It's all behind the scenes.

Greg Gibas

Okay. Appreciate it.

Operator

Thank you. Ladies and gentlemen, we have reached the end of the question-and-answer session. This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.