



Trupanion, Inc.

Third Quarter 2022 Earnings Conference 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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Margi Tooth, *President*

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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

Shweta Khajuria, *Evercore ISI*

Corey Grady, *Jefferies*

John Barnidge, *Piper Sandler*

Josh Shanker, *Bank of America Merrill Lynch*

Elliot Wilbur, *Raymond James*

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

Laura Bainbridge

Good afternoon, and welcome to Trupanion's Third Quarter 2022 Financial Results Conference Call. Participating on today's call are Margi Tooth, President; Drew Wolff, Chief Financial Officer; and joining us remotely from Europe, Darryl Rawlings, Chief Executive Officer. Similar to prior earnings calls Tricia Plouf, Chief Operating Officer, 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 performance 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, 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 expense. 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, and good afternoon. Total revenue in the quarter grew 29% to approximately \$234 million. Adjusted operating income was \$22 million, up 6% year-over-year. We invested \$20 million of this acquiring pets at a 37% estimated internal rate of return. We continue to invest in areas where we believe we can achieve high internal rates of return. In today's environment, I'm especially pleased with the discipline the team has shown in managing to our internal rate of return guardrails.

In the quarter this translated to strong growth within our core subscription business. We added over 70,000 new subscription pets driven primarily from the veterinary channel. We achieve this record growth while also sustaining our high levels of retention. As you've heard me say before, in times of uncertainty, the need for Trupanion growth. Our monthly recurring business model drives consistency and results. In fact, our total revenue growth has exceeded 20% every year for the last 10-plus years.

I'm proud of this growth. I am most focused on growing adjusted operating income. Adjusted operating income represents the funds we have to grow our business, and I believe it is a proxy for our value creation. The more adjusted operating income we have, the more we're able to reinvest at our high internal rates of return and increase the intrinsic value of our Company.

In Q3, subscription adjusted operating margin was 12.8% below my expectations, and driven by price. This is the one key metric I was disappointed in for the quarter. If the team is focused and continues taking action on price, not only for the accelerated rate of inflation we're seeing today, but also for that which we expect will come, I am confident that we'll get back to our targeted adjusted operating margin of 15% by the end of 2023. Margi, as a leader of our 60-month plan, is monitoring these efforts, making sure we have clear ownership focus and resources to quickly and effectively get ahead of the changes we are seeing in veterinary medicine.

Now, let's get back to the fundamentals. We are in a large under penetrated market. Today 97% of pet owners do not have pet medical insurance and are therefore choosing to self-insure. With the rising cost of care and the growing human pet bond, the need for Trupanion is greater than ever. In our monthly

subscription business growth in pet count and ARPU drives higher lifetime value, higher lifetime value drives higher allowable pet acquisition costs and greater sums of capital we can deploy efficiently. The team has a strong track record of doing so. In the last five years, we've grown our adjusted operating income over 300% and deployed this capital consistently within our target internal rate of return of 30% to 40%.

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

Margi Tooth

Thank you, Darryl. I'll start by reviewing our quarterly growth metrics and how today's environment presents a unique opportunity for Trupanion. I'll then discuss the actions we're taking to ensure we're well-positioned for where the industry is headed. It was a particularly strong growth quarter. We added over 70,000 new pets in our subscription business, a new quarterly record. Growth was primarily driven by the veterinary channel reflecting ongoing demand for veterinary care. In the quarter, veterinary leads were at an all-time high.

Our pet acquisition spend continues to reflect all efforts to generate leads, convert pet owners to members and welcome members during their first year with us. I'll echo Darryl's sentiment that we were very encouraged by the efficiency of all elements of the spend during the quarter. This effective capital deployment ultimately helped drive our estimated internal rate of return to well within our 30% to 40% target range.

Year-to-date, we have deployed approximately \$60 million to add over 190,000 new subscription pets. At our current ARPU of around \$64, and assuming an average life of 78 months, this new cohort of pets will generate almost \$1 billion in afford revenue, and this is before inflation. Encouragingly, we continue to see the veterinary industry adjust their pricing models. They absolutely cannot afford not to, and yet at the same time, people's disposable income is stagnating. The cost of self-insure is getting more expensive. It is an increasingly poor solution.

As more and more pets enter the community, this higher percentage of insured clients can give veterinarians the confidence to continue to raise prices. This in turn helps solve the challenges they face such as staffing. This is positive news to the industry in general and for us specifically to see these prices come through. It makes the conversation around budgeting for unexpected veterinary expenses more relevant than ever. However, it also requires meticulous execution, exceptional analysis, and constant review from within Trupanion to stay true to our value proposition and the pricing promise we commit to our members.

In the third quarter, we fell short of our 71% value proposition by 2.5%. Absent the impact of mix changes, cost of invoices was up approximately 10% over the prior year period outpacing our average rate increase of 7% for the same period. As Darryl alluded, we are taking actions to get ahead of the changes we are seeing in veterinary medicine. Absent the impact of changes in mix, we now have pricing increases of 11% flowing through into early 2023 with another 7% planned going into next year.

We will continue to closely monitor the rate of inflation, and are poised to roll forward additional pricing adjustments as needed in the coming months. As a reminder, rate changes are immediate for new enrollments, but are applied for existing pets once every 12 months so the impact of these changes will flow through in 2023 with a full benefit showing up in late 2023 when we anticipate being back on track to hit our margin target.

At the same time, our member experience teams have been focused on ensuring that our commitment to members regarding our value proposition is well understood and maintained. Our pricing promise is our pledge to pet owners that we price for the life of the pet, never punish unlucky pets and price accurately to our value proposition across our millions of categories. If in aggregate we overshoot our 15% subscription margin target, we will make it right. This is our pricing promise.

In the coming years, the need for Trupanion and to budget and care for the unexpected will only grow. This need is universal, and so too are our aspirations. International expansion is an important building block of our 60-month plan, and I'm very proud of the progress of team was made on this front year-to-date. We've started to see some acceleration in Australia, have team members in place in Japan, and just recently announced two strategic acquisitions to officially mark our entrance into continental Europe to take our new geographies to the cusp of revenue generation.

There are over 40,000 veterinary hospitals spanning Continental Europe, and our acquisition of Smart Paws and our pending acquisition of PetExpert gives us immediate access to over 12,000 of these, increasing our addressable market. PetExpert provides high value pet insurance to approximately 25,000 pet owners in the Czech Republic and Slovakia, and works closely with veterinarians to provide high quality partner support to hospitals.

This same synergy is also evident in Smart Paws, our recently completed acquisition. While smaller in scale than PetExpert, Smart Paws brings with it a team and infrastructure to further enable rapid expansion, and parallel to our North American Foundation, deep relationships across the European veterinary community. We're excited for these acquisitions and their pet passionate teams provide a platform for us to bring Trupanion and our world-leading member experience to these new and underpenetrated markets.

Together we have taken several steps forward in achieving our global mission to help the pets we all love receive the best veterinary care. The opportunity is significant and we are well poised to build on it.

With that, I'll hand over to Drew to walk through our financial results in more detail. Drew?

Drew Wolff

Thanks, Margi, and good afternoon, everyone. Today I'll share additional details around our Q3 performance, as well as provide an update on how we're tracking against our annual goals.

Total revenue for the quarter was \$233.8 million, up 29% year-over-year, and continued to be driven by strong pet additions and sustained high levels of retention in our Subscription Business, along with growth in our other business. Within our Subscription Business segment, revenue was \$152.4 million, up 20% over last year. As with the last quarter, the ongoing strength of the U.S. dollar had meaningful impact on our results.

On a constant currency basis, subscription revenue would've been \$153.7 million, or up 21% year-over-year. Total enrolled subscription pets increased 19% year-over-year to over 808,000 pets. Average monthly retention, which is calculated on a trailing 12-month basis, was 98.71% equating to an average life of 78 months. Monthly average revenue per pet was \$63.80, up 1.1% year-over-year on a constant currency basis.

ARPU growth continues to be impacted by mix of business. For context, we continue to see accelerated growth in new pet enrollments in lower income areas that, combined with business and product mix, match the price increases rolling through our book of business. After adjusting for this mix impact, the average pricing change across our book goes from 1.1% to the 7% that Margi referenced earlier. This is behind the cost of veterinary invoices, which increased approximately 10% over the same time period.

As a result, our loss ratio in the quarter expanded 70 basis points from the prior quarter to 73.5%. As a percentage of subscription revenue, variable expenses were 9.7%, down from 9.9% in the prior year period. Fixed expenses, at 4% of revenue, were also down from 4.3% sequentially and 4.8% year-over-year, reflecting additional cost actions in the quarter to drive operating leverage and partially offset the increase in our loss ratio.

After the cost of paying veterinary invoices, variable expenses and fixed expenses, we calculate our adjusted operating income. In dollars our subscription business delivered adjusted operating income of \$19.5 million, an increase of 5% over the prior year period. On a constant currency basis, subscription adjusted operating income would've been \$19.7 million, up 6% year-over-year. As a percent of subscription revenue our adjusted operating margin was 12.8%.

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 a different margin profile than our subscription business. Total revenue for the other business segment was \$81.4 million. Compared to the prior year quarter this is an increase of 49% year-over-year reflecting an increase in the number of pets enrolled. Adjusted operating income for the segment was approximately \$2.5 million. As a result, our total adjusted operating income was \$22 million. During the quarter, we invested 15% more year-over-year, or \$20.1 million, to acquire over 70,000 new subscription pets. This resulted in a pet acquisition cost of \$268, an estimated 37% internal rate of return for a single average pet.

We also invested \$2.4 million or 1% of revenue in the quarter on development expense. This reflects a ramp up of our international activity as well as ongoing support for new distribution channels, which we expect will run through year end. This resulted in an Adjusted EBITDA loss of \$900,000 compared to an Adjusted EBITDA gain of \$2.2 million in the prior year quarter.

Total stock-based compensation expense was \$8.3 million in line with our expectations. Net loss for the quarter was \$12.9 million, or a loss of \$0.32 per basic and diluted share compared to a net loss of \$6.8 million or a loss of \$0.17 per basic and diluted share in the prior year period.

Turning to our balance sheet. We ended the quarter with approximately \$238 million in cash and investments. We held approximately \$54 million in debt with \$90 million available under our long-term credit facility. As Margi mentioned, we recently completed one acquisition and announced another, both in continental Europe. In the fourth quarter, we will add about 25,000 new pet policies to our subscription business as a result of these acquisitions. We do not expect any material impact to our financials in the fourth quarter.

In terms of cash flow, operating cash flow was negative \$2.3 million in the quarter compared to positive \$6.2 million in the prior year period. Capital expenditures totaled \$4.1 million in the quarter, and as a result, free cash flow was a negative \$6.4 million.

I'll now briefly discuss how we're tracking for the remainder of the year. We continue to expect consistent growth in revenue and are reintroducing an estimate range for the year to provide more clarity on our business given the current macro conditions. For 2022, we expect total revenue in the range of \$900 million to \$902 million. At the midpoint this will result in a growth rate of 29% over the prior year. Subscription revenue is expected to be in the range of \$595 million to \$596 million. At the midpoint, this will result in a growth rate of 20% over the prior year. Total adjusted operating income, or the dollars we have to invest in growth, is expected to be in the range of \$87 million to \$89 million. At the midpoint, this is up 12% over last year

Also, please keep in mind that our projections are subject to foreign exchange rate fluctuations. For our full year guidance, we used a 73% Canadian to U.S. conversion rate in our projections, which was the approximate rate at the end of September. Looking into 2023, we have line of sight to our target 15% adjusted operating margin by year-end, primarily reflecting our pricing actions. We expect to provide formal 2023 guidance on our year-end call in February.

Thank you for your time. With that, we'll open it up for questions.

Operator

Thank you. Our first question will be from the line of Shweta Khajuria with Evercore ISI. You may go ahead.

Shweta Khajuria

Okay, thank you for taking my questions. How should we think about ARPU growth going forward? You gave great context in terms of pricing changes, but I'm not sure if I fully understood how it impacts the overall business, so could you please help us with that?

Then the second question is on your acquisitions. The most recent one you announced today is expected to close in the fourth quarter. How should we think about your goals for synergies coming into 2023 and then expansion going forward? Thank you.

Tricia Plouf

Hi, Shweta. This is Tricia. I'll kick it off with the first question and then I think Margi will touch on the second question. When it comes to (inaudible) ARPU growth, as I'm sure you noticed in the script, so I'm talking at a macro level about absent changes in mix, what we have that is flowing through into next year, 11% with an additional seven plans to be filed—already filed or to be filed in the next 30 days so that we're positioned well if current inflationary rates continuing to next year.

Now obviously when it comes to how this then translates over the course of the year as well as on the financial statements, it does take time to roll on. We won't see the full impact coming until the back half of the year. We'll definitely start, absent dramatic changes in the types of enrollments we get now. We do expect on the financials, even when you account for the mix shift, that we're at a lower rate right now and that will start to move up and it'll move up over the course of the year.

Drew, do you want to—do you have anything to add about, more on how to expect this to roll through on the financials?

Drew Wolff

Yes. Given all this mix impact and assuming constant currency, which is really important because there's significant FX headwinds that we're going in the year with. We're looking at an average for the full year 2023 at 5% for ARPU. As Tricia mentioned that that builds throughout the year and it's back half loaded, but that gets us back to an average price increase that we saw in 2019, in 2020 and half of 2021. I'd start 5% for 2023.

Shweta Khajuria

Thanks, Tricia and Drew. Just a quick follow up on that before the next question, before you address the next question. How should we think about the exit rate of ARPU growth for 2023? Is it fair to say... Well, you tell us.

Tricia Plouf

Yes, I would say obviously we're still mapping out next year and we'll give a lot more visibility on the February call. With projecting our current rates of inflation and the rates we have flowing through to average 5% for the full year, it's above 5% in the back half of the year. We can give you more visibility as we go into next year, but that's how to think about it. We'll be exiting at a higher rate than that.

Shweta Khajuria

Okay, Thanks, Tricia.

Margi Tooth

Okay. Hi Sheweta. I'll pick up the second one, it's Margi. Just in terms of the acquisition that you mentioned, so today we announced the acquisition of PetExpert. This will close, as you said, in Q4. In terms of synergies, PetExpert really is a key part of our 60-month plan. It's going to increase our addressable market in general. They're very vet centric, so much like Trupanion their foundation is in through partnerships with the veterinary community, making sure they can solve the issues as being out of pocket and reimbursement.

They have the ability to continue what we've been doing in North America for quicker, faster payment. For us it's really about how do we get to those markets with people that are aligned to our core, which is vet, and being able to work with people who are like-minded with products that will be very similar to Trupanion and really kind of help us build that market in time. It is very underpenetrated in continental Europe, so they're definitely going to help us get a foot in the door very quickly in 2023.

Shweta Khajuria

Okay. Thank you, Margi.

Operator

Okay, our next question is from Corey Grady with Jefferies. Please go ahead.

Corey Grady

Hey, thanks for taking my question. I want to ask first about retention. You break out retention to three buckets in your shareholder letters, but can you talk about maybe other factors that impact retention and if there are any other factors besides price behind the step back this quarter? Thanks.

Margi Tooth

Yes, I'll take it at my level. In terms of our retention, it's strong, it's near an all time high. I think we have a good pathway towards that 60-month plan, which is on 99% achievement. You're right, we do break it out into three buckets and typically the impact to that, aside from pet passing away, we also have the financial implications very occasionally, but typically it comes down to understanding the value proposition. We don't lose many pets, so when we look at our overall attention rate, we're not talking about a high volume here.

The issues are always very, very minor. That's why we're at that point now with the team executing, they're looking at those tiny incremental things they can do to adjust the way that people think about their product. I think in terms of other issues, we're not seeing anything different. I think the main thing for us is making sure that we explain why Trupanion and we explain the value proposition and we help them understand the cost plus model that we have. I would say that the way that we've been managing it for the last on the top for several quarters has been very strong and we've seen continuous improvements through that.

The biggest thing that, if there is any headwind for us, is typically when you see that faster rate of growth and to reiterate what you heard earlier with 70,000 new adds in the quarter, we do often say, how do we make sure we're focusing on that fast growth and offsetting that first year retention? Because that's the weakest point of the journey if there is a weak point. That comes back to the point of the value proposition and reiterating that to people. There isn't anything further that I would add. Darryl, would you add anything?

Darryl Rawlings

No, you pointed out, we've been coming off quarters of about 60,000 new pets and we just added 70,000, a new record, and that 10,000 incremental pets have an impact on retention. But yes, retention overall is strong.

Corey Grady

Got it. Thanks. Then I also wanted to ask about this with pet acquisition costs. You demonstrated some flexibility on PAC this quarter and you still put up very strong gross adds. Can you talk about where the flexibility on acquisition spend is coming from, and then how should we think about gross adds going forward with PAC down in the quarter?

Margi Tooth

Yes, sure. I can start this off and then hand over to Drew for the second part of the question, but in terms of overall PAC efficiency, as we went through the quarter, I'm very impressed and proud of the team with the way they were able to flex the muscles and pull on the levers that we built over the years. Going through the quarter, they really—they understood that our margin was down, so we adjusted our PACs then to see that and in doing so created—we added 10,000 more pets for the same amount of money from Q2. Really efficient spend.

In terms of the flexibility, we're always looking at making sure that we're refined in what we can do. I think they've proven time and again, that quarter-over-quarter, we can live within those guard rails that we've set ourselves, which is a high bar. It's good execution develops those results in Q3. Drew, would you add?

Drew Wolff

Well, just on the question about forward PAC, I would emphasize that it's an output of our lifetime value and so we flex in order to—we solve for what we can afford to spend in order to drive growth. It's an output and we're not subject to the whims of the market. I would also emphasize that it includes everything. It's fully loaded as there's all this marketing and sales and marketing people, IT people are in that, so it's not as we typically think of a marginal advertising PAC, which is important.

Margi Tooth

I will just add one other thing to that, and we think about our PAC moving forwards through the rest of the year and through the quarter. We do have our territory partner conference coming up. To Drew's point, when we think about all the people that we include within our (inaudible), the territory partner conference is our sales conference. It's an important factor of our calendar. We haven't been able to have it for three years for obvious reasons. Bringing our TPs together for the first time in three years as a sales group will be a really important long term move for us. It's not going to have immediate gain in November or December, but we do see there benefit for the subsequent 12 months after the conference. While we're excited to have them in Seattle, it does hit our PAC in one quarter. To Drew's point, that all gets fully loaded in there.

Corey Grady

Very helpful. Thank you.

Operator

Our next question is from the line of John Barnidge with Piper Sandler. Please go ahead.

John Barnidge

Thank you very much for the opportunity. My question is on the acquisitions in Europe, can you maybe talk about how Smart Paws and PetExpert will look different versus what is already in the market? Then how do you think it'll look different than the U.S. and Canadian Trupanion current offering?

Margi Tooth

Yes, sure. Smart Paws and PetExpert, just to touch on what I mentioned earlier, it really is they're both key acquisitions to help us in our 60-month plan. We talk about our increasing our addressable market and both of those will allow us to do that across continental Europe. In terms of the offering, it's still early stages. As we mentioned, the PetExpert deal should close this quarter. The key for us is making sure we have brand consistency and as close as possible product consistency across the world globally. We recognize there will likely be localizations for those products depending on what the markets dictate to a certain degree, but we feel very confident that our product is a global leader, our retention rates are global leaders.

In doing so, having that vet centricity means there are certain parts of our product that are hard to replicate, that they really do what they say, they solve the same problem no matter which country you're in. We'll maintain that as close as possibly we can. At this stage, in terms of the specific differences between the North American product, which is the same in Canada and the U.S., we wouldn't be able to share specifics as to what that looks like, but you can expect them to be very similar.

John Barnidge

Thank you for the answer and my follow up, as I look at ARPU, how should we think about the size on a per dollar amount, FX is headwinds, and then how should we be thinking about that for within that vein of the 5% growth?

Drew Wolff

Well, we're currently using a conversion rate at 73%. If you even just look at what it was last year, looking out that is—could be 2% to 3% headwinds next year. Obviously it all depends, things move, but that's currently the rate we're using and the assumption we're using, and that would be on—so the 5% is a constant currency basis and then reported might be different than that based on FX.

John Barnidge

Thank you very much.

Operator

Our next question is from the line of Josh Shanker with Bank of America. Please go ahead.

Josh Shanker

Yes, thank you very much for taking my question. I just want to understand the 11% and 7%; 11% is the rate that's in the pricing of enrolled pets at the—as of September 30 and 7% is rate approvals that have yet to impact the pricing?

Tricia Plouf

Yes, so good question. Let me map it out because I know it can be a little difficult. We had, going through the third quarter, 7% rate. During the third quarter and into the October we did additional filings, which now brings what we were rolling through which was 7% up to the 11% that I mentioned. That 11% is fully approved, not waiting for anything. The effective dates are set.

Now question of, so that's the run rate that we should expect as some of the approvals have just been within recent weeks. Those will start ramping up and that's our run rate going into Q4 and then Q1 of next year. The 11% is known and ready to notice customers and start moving through the book.

We desire to and have plans to do an additional 7%; 3% of that 7% we've already filed. We're waiting on approval; 2% of that we believe is imminent. Then the remaining 4% that we plan to have as we want to be aggressive in this going into next year, we'll be filing over the next 30 days. Eleven percent is fully baked, known, and then of the 7% we filed for 3% of it and expect that to be approved very quickly. Then the remaining 4% will be filed in the next 30 days, all to really go into next year more aggressive as we look to keeping up, continuing to keep up and bridge that gap on inflation. Does that help?

Josh Shanker

Yes. How much price is embedded in the \$152 million of subscription revenue that you wrote in the quarter?

Darryl Rawlings

How much price?

Tricia Plouf

Well, that included roughly 7% rate increases, but after changes in mix and FX, it was right around 1% increase.

Josh Shanker

Okay. Seven percent price, but ARPU is 1%, that's fine. Then my other question on the 56,000 pets, I think you said that they're going to become subscription pets because of the acquisition, and I might have gotten that number wrong. Is the character of that book similar to the subscription business in general, that when we call them subscription pets, they should be expected to have the same kind of return profile as the current Trupanion subscription book?

Darryl Rawlings

Yes, this is Darryl, that is correct. The business in Europe is going to have different ARPUs in different countries, obviously, reflecting the different costs of veterinary care, but all of them are—will over time be targeting the 15% adjusted operating margin. They should all be targeting the same as well as the same internal rate of return guardrails. It will take a little bit of time over the next year or two for that to show up in our GAAP financials in the same way. That is because right now these companies are operating as MGAs, so they're only going to see a percentage of the revenue hit our P&L until it becomes in our own underwriter.

Josh Shanker

Okay. Thank you very much.

Drew Wolff

Then just for one correction, I think you said 56,000, it's actually 25,000.

Josh Shanker

I'm sorry. I was writing too fast. No problem. Thank you very much.

Operator

Our next question is from Elliot Wilbur with Raymond James. Please go ahead.

Elliot Wilbur

Thanks. Good afternoon. Just two quick clarification questions. First for Tricia, thinking about the 11% and the 7%, so simplistically, would I just add those or multiply those together to get a compounded inflation rate, say, exiting 2023?

Tricia Plouf

In general, where—essentially how this is going to roll through the book in terms of ARPU is when something is approved, so we know the 11% is approved, those increases hit members on their annual anniversary date. One-twelfth roughly rolled through the book at any given time. With the 11% and then as the 7% comes on board, it will start to build and it really does build sequentially. As we look through and we're looking at the vet trends in general, anticipating double digit inflation to continue. We're making sure we're being aggressive in anticipation of that and pricing through it.

Then the pricing will roll through the book. Obviously how things actually play out on the claims, the cost remains to be seen, but we want to be very proactive in anticipation that current trends will continue and have been pushing these rates in anticipation of that, and to your question, it'll build and on kind of a what are people—what is our book getting on average when it's all rolling through? That is the 11% plus the 7%, that's the 18% by the end of next year, that, absent any changes in mix, pets on our current book would be getting next year on average.

Then obviously as you can see in our current financials, when new pet mix comes in, which is enrolling currently at a slightly lower amount, that brings the average down as well as any changes in FX as well. You can kind of use that same relativity that we talked about to map out how that looks when it hits the financials. I don't know if anyone else has anything to add to that.

Elliot Wilbur

Okay. That was helpful. Then I want to ask a follow up question. With respect to the acquisition, Smart Paws and PetExpert as well, wasn't clear to me exactly when those would start appearing in your financial statements. Is that different from when you would add them to new pet add and PAC figures? Then with respect to these businesses, could you just give us a sense of where they stand with respect to your current financial guardrails and IRR targets and basically how long you generally expect it to be before these businesses can hit those rates?

Drew Wolff

Yes. As Darryl said, these are MGAs, so they're not the—they're not the full stack. You don't have the full gross written premium hitting revenue. You just have the commission. Smart Paws, small; PetExpert is bigger, but—so they will, Smart Paws is closed. PetExpert will close this quarter. They will be in our books starting this year. We'll only have one month of revenue. It won't be material that way. They have very—they're going into subscription because we're targeting similar margins to our existing Trupanion business. Going into next year when we give an update on 2023 in January, we're looking to grow these businesses. Relative to Trupanion they're not big, but we're looking to grow. They'll be in our guidance when we talk in February.

Margi Tooth

I can add to that too, just in terms of the synergies that we touched on earlier with these two companies. We've chosen to partner with them and bring them into our Trupanion family because of their ability to

grow in the way they think about their business. They think lean, they think like (inaudible) operator, they have the same drivers and tenets that we value very much as a business. In terms of how quickly we can get to those central guardrails, they're set up really well. Initially, we're working with two teams who understand how to run a business as we do and we're looking forward to seeing that impact in 2023.

Elliot Wilbur

Okay. If I could ask one additional follow up question for yourself, Margi. Can you just maybe provide a little bit more granularity in terms of what drove the strength in new pet adds in the period? I guess with the contraction in clinic visits there's been some expectation, of course, that it would be more difficult to add new pets, and you guys seem to be proving that theory wrong. Is it just function of better leads, better conversions, more hospitals being called on or existing client base being called on more frequently? Just maybe some of the key dynamics that enable you to continue to overperform on that metric. Thanks.

Margi Tooth

Yes, of course. You've actually touched on many of the reasons why actually. When we think about the overall growth pet adds through the quarter, it was led by the veterinary channel predominantly. Really, really happy to see that continuing to get stronger as record levels, record levels of leads. To answer that question regarding leads and conversions, both were up. We've talked a lot about conversion, how we're focusing there. The team executed really strongly with some tactics they've been planning for several months and we're starting to see them come through, have that coupled with lead volume. You see both of those things are going to start to drive some strong return in the back channel.

Our other channels continue to perform strongly. One of the things we have made very clear in our distribution strategy for our 60-month planners is that we have multiple channels. We have multiple opportunities to continue to grow in an underpenetrated market and happy to see them continue to go up. We're growing faster in areas where the vet costs, we see there is a need for our product. We solve the problem of budgeting for the unexpected, and that helps us. Yes, vet visits are down, but that doesn't mean—that's not reflected in our number because at the end of the day, that's the seeing the value in our product. They're having good conversations. Our territory partners have been back now in the field consistently for six months and more through this quarter. That continued conversation coupled with the fact that we've had record rates of software installation, the kind of thing that really sets us apart in the industry, has gone up as well.

There are a number of really positive factors that set us up well for the future. I think the biggest thing for us is really to remember that we are priced to support the needs of the vets and the needs of the pet owners. We are seeing that that value proposition, the relationship and that core channel for us, that channel is performing very well. It's positive, really positive story for us, quarter to second half.

Darryl Rawlings

I'll just add a little on top of it. This Company has been around for over 20 years. We've been through multiple recessions, we've been through high impact times of change, and the veterinarian message becomes stronger and more compelling at times when people have concerns and particularly when they're financial concerns. All the headlines are talking about inflation. People are hearing the word recession, and that increases the likelihood that veterinarians want to communicate to new pet owners about the need for high quality medical insurance and why that message is going to resonate stronger to people. If you go back a couple years ago, a lot of times when some people think that it's easier for us to grow, it's the opposite. When our messages are compelling to veterinarians to help people budget for their pet and we're seeing that across the board with vet leads.

One thing that I think I just want to point out is, our new pets grew from about 60,000 new pets to about 70,000. Of that 10,000 incremental in the quarter, about two-thirds of that came from the veterinary channel, and they were mainly driven in areas of lower income. This product is not designed for rich

people. Rich people can self-insure. For the people that have a tighter budgets, they need a solution. Our solution resonates and veterinarians can drive that message. That comes across in our lower PAC dollar spend and the efficiencies we're having. There'll be puts and takes if we move into a recession over the year. The inflation of ARPU going up will help us on growing our revenue, make that a little bit easier. Messaging will be stronger to vet hospitals, but we'll have some other areas that'll be a little bit more challenging. We expect another strong year of growth.

Operator

Our next question is from the line of Ryan Tunis with Autonomous Research. Please go ahead.

Ryan Tunis

Hey, thanks. Good evening. Just another follow up on the rate discussion. The 18 points of rate, the 7% and 11% to the end of 2023, is that on top of the 7% we're observing now? Should we think about the cumulative of 2022 and 2023 as 25% or is 18% the number to think of over the two-year period?

Tricia Plouf

Yes, no, we're looking at 18%, at least currently, as what, when you add it together, rolls through. We really took the 7% and increased it to 11% as some of the 7% falls off as it related to things that had already been in place. We upped the 7%, and then added to that to 11%, and then we'll add again to get that up to 18%. That's the top end. Obviously, we're looking at this on a weekly basis. We're leveraging data from many different sources, our TPs that are in the field, the data that we already have, relationships with many of the groups as well as the veterinary CPIs. If we see things change and we need more, we are absolutely poised to do that as well and to make sure we're being aggressive. But this is the visibility we have right now that we're acting on and feel good about it going into next year.

Ryan Tunis

Understood. Then can you maybe give us a little bit of a breakdown from a loss trend perspective, frequency, severity, what you saw year-over-year? What you maybe learned this quarter relative to first half of the year or the second?

Tricia Plouf

Yes, at a high level, and I'll speak more about when we look at things absent dramatic changes in mix, going into the year as we've talked about before, particularly in the first quarter, as we were coming out of COVID, we definitely saw more changes in frequency with people going back, checking—catching up on things, small, more normal-ish, call it 2% year-over-year changes in severity, but nothing overly dramatic. We started to see movement and severity in the second quarter increasing. Then we've seen more movement in severity year-over-year going into the third quarter.

Now, the increase that we talked about of cost of claims going up about 10% absent of mix changes, it still has some frequency. It's about half frequency, half severity that we're seeing. When we see both of those moving, many times historically we've seen severity go up, but frequency doesn't tend to go up as much. We're more seeing both of those moving, we definitely want to be more aggressive, and we've seen severity tick up every quarter so far this year, as boosting overall inflation move in general.

Ryan Tunis

Got it. My follow up then would just be, if the plan is for 18% rate over these two years and we're running at 10% loss trend and that's accelerating, why wouldn't the plan be to take a little bit more rate? Then the one other I had was, just on deductibles. What impact does inflation have in terms—is that—could that potentially be a reason why you're picking up more frequency, just more attachment? Thanks

Tricia Plouf

There's a variety of reasons that we're seeing more frequency. One is, I think we weren't surprised to see it coming out of COVID, like I mentioned. Also, as more and more hospitals use our software, we tend to see a little bit of a step up in frequency because it's just much more easy to submit those and that's a good thing. That's more of a small one-time step up. That tends to be the frequency. Now we have had rate flowing through, so we have a current gap of 3% and we're looking at that combined with continued inflation into next year and that's where we're getting to the 18%. Obviously if we see trends change we'll react to that very quickly.

Ryan Tunis

Thanks.

Operator

Our next question is from Maria Ripps with Canaccord. Please go ahead.

Maria Ripps

Great, thanks so much for taking my questions. Just following up on retention. As you started passing along this higher magnitude rate increases onto your member base, are you seeing any signs of elevated churn among those subs that got pricing increases so far? How are consumers responding to this higher prices, especially given the macro backdrop?

Margi Tooth

Yes, hi Maria, it's Margi. Just at a high level, I would say our retention rate has held really strong. We're not seeing any signs of elevated retention across those buckets. One, in the event that, when you look at a granular level, so we've got our three buckets. The first year of retention, those with an under 20% rate increase and those with an over 20% rate increase, that's where you tend to see some of the differences. The first year bucket has been one that has slightly changed, not because of our rate of increase but pet growth. As we talk about that relationship between you add more pets, you're going to obviously see more people in that first year.

In general we haven't seen anything that causes any concern. I think as we think future state, as we think about this aggressive pricing strategy that Tricia has been outlining, we really are making sure that we've got our teams aligned to be able to be ready to support anything that we're seeing. If we see increased calls, if we have different conversations based on what's happening in the macro environment, we want to be ready to be able to really reiterate and explain our value proposition and really staying true to that, which is why we alluded to the pricing promise earlier as well, just making sure people understand what's involved, what goes into budgeting for their pets and helping them to really get their arms around that. So far so good.

Maria Ripps

Got it. Margi, you talked about key drivers for strong additions in the quarter. Did any of your new initiatives contribute to this strong growth additions in Q3?

Margi Tooth

When we think about the 70,000 pets. Seventy thousand is around 10,000 pets more than we have seen on our run rate. When we think about that and how it's broken up, (inaudible) came from new initiatives, so not significant volume, it's nice to have that but it is additive, but the bulk of that growth came through

the vet channel, came through that core channel, came from the fact that we've got our territory partners out in the field really reinforcing the moat that we have the strength of connection with vets at a time when they really need to make sure that clients can afford this care. That's really where that halo effect came from our overall pet growth. While they're contributing, they're not the driver of that growth.

Maria Ripps

Got it. That's very helpful. Thank you so much.

Operator

Our next question is from Jon Block with Stifel. Please go ahead.

Tom

Tom (phon) on for Jon. Thanks for the questions. If I can start with retention, it was down a little bit quarter-over-quarter and piggybacking off the last question, but with pricing growth accelerating substantially in the coming quarters, do you have confidence retention will either maintain at its current levels or do you think it'll climb back to the 98.74%-ish range? I'd just love your thoughts on how we should think about price going up so much and the impact on churn.

Darryl Rawlings

Sure. Well, to start with, I hope anybody on the call recognizes any time that you're talking about 98 point something, we've got high retention, the fact that we're talking about 98.7% and is very high. We believe that our retention rate compared to the category is significantly higher. If the retention rate goes back to, let's say, 98.6%, which would still be leading the category, that would have a little bit of downside on our total net pet growth, but the offset on having 18% rate increases of what that'll do to drive our revenue growth is well offset. We've been through this type of cycle before in small regional areas (inaudible), and it's most important that we price accurately and we'll take the revenue growth benefits from the ARPU and we might get a small subtraction on retention, but net over, it will help our revenue growth and it'll also more importantly help our adjusted operating income and our lifetime value. We'll be pleased.

Tom

Okay. Moving forward, maybe model sequential very small down ticks in the retention, is that fair?

Darryl Rawlings

Yes, it depends on if Margi continues to, and the team continue to have accelerated growth. Remember our lowest retention is in that first year retention. If we keep having accelerated growth, that brings down our blended retention more than anything else. If we're putting in bit more—if there's more people in the 20% plus bucket, that will have a smaller impact. But like I say, it'll be more than offset by increased revenue growth.

Tom

Got it. That's helpful. Then my second question is just on gross adds, really strong in the quarter. Maybe first quickly, did the Smart Paws acquisition contribute to that number at all?

Margi Tooth

No, it didn't.

Tom

Got it. Okay. The strength, it sounded like it came from the vet channel. Margi, you just mentioned this a bit, but can you provide some more color just around leads and conversion outside the vet channel with those new initiatives? Is that one-third contribution that you talked about in the 10,000 incremental pets, is that typical, relative to history?

Then my last one, what is your level of confidence in these gross add levels persisting, moving forward? Can we expect to grow sequentially off these 70,000 levels? Thank you.

Margi Tooth

Yes, sure. I'm, going to try and make sure I hit that from the top, so please forgive me if I forget some of those things. Initially from a—in terms of the strengths, yes, it did come through, majority of growth in the vet channel, but I will say all of our channels for us (inaudible) and conversion, which is great. It really plays into our broadened distribution strategy. Always helpful to have growth across the mix of channels we have there.

In terms of the one-third contribution, it's not typical. We really took a step up in Q3 through that vet channel and that was, like I said, primarily driven through the vet. The combination of all the things happening in the world, the vet's being back there at full strength, but still under massive pressure, they're at full strength, our territory partners being back out, they're really reiterating, seeing the depth of our software penetration really starting to expand. There are all these things that combine that are helping to make the conversation about the need to budget for the unexpected care is really helpful.

When we think about the growth, we expect year-over-year and quarter-over-quarter to have sustained revenue growth. I feel confident moving into the quarter, based on the way the team has performed and continues to perform and the analysis they're doing, that we feel confident in being able to maintain that sustained revenue growth would be the combination of the ARPU and the pet growth mix.

Tom

Perfect. Thanks, Margi.

Operator

Our next question will be our last question today, and it'll be from Greg Gibas with Northland Securities. Please go ahead, sir,

Greg Gibas

Hey, thanks for taking the questions. Thanks to the insights too on a claim activity being higher than normal. Are you seeing that begin to stabilize in Q4? Or is that expected to persist awhile?

Tricia Plouf

Yes, hi Greg, it's Tricia. We're one month into Q4. I would say with October behind us, in general we're seeing—October's typically a bigger month for us in any given year given there's no holidays and it's a month with 31 days. We're seeing October in similar run rates to what we've seen in Q3. We're not seeing dramatic step up, we're not seeing dramatic step downs. It's continuing in terms of what I mentioned, the frequency and severity on a similar pace, which we use to help guide us when we projected out into next year those numbers that I mentioned that we would need and really been prompted up with the plans that we put in place as well, taking October into account.

Greg Gibas

Okay. Got it. If I could follow up on PetExpert, maybe what rough percentage share of the market do they have? What is the total penetration rate in the Czech Republic and Slovakia? Then what pace would we maybe see them or you guys expand into new European markets going forward?

Darryl Rawlings

Well, we're hoping to close the deal this—we will be closing the deal this quarter. Super excited about the team. Market penetrations in the country are about 5%, which is pretty consistent with a lot of continental Europe, so well behind the U.K. and Sweden. A lot of opportunity for growth. Obviously in countries where the cost of veterinary care is lower and the ARPU is lower and lifetime value will be lower, so you have to apply a lower pet acquisition cost to get you the same internal rates of return but they've been able to prove to do that and we think that we can help them grow aggressively for the next four years to five years to come and super excited about it.

Greg Gibas

Great. Thank you.

Operator

That does conclude the conference call for today. We thank you all for your participation and kindly ask that you please disconnect your lines. Have a great day, everyone.