



Trupanion, Inc.

Second Quarter 2023 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

Maria Ripps, *Canaccord*

Shweta Khajuria, *Evercore ISI*

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Jon Block, *Stifel*

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Katie Sakys, *Autonomous Research*

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

Operator

Good day, and welcome to the Trupanion Second Quarter 2023 Earnings Call. (Operator Instructions).

Please note that this event is being recorded.

I would now like to turn the conference over to Laura Bainbridge with Investor Relations. Please go ahead.

Laura Bainbridge

Good afternoon, and welcome to Trupanion's second quarter 2023 financial results conference call.

Participating on today's call are Darryl Rawlings, Chief Executive Officer; Margi Tooth, President; and Wei Li, Interim Chief Financial Officer.

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 provisions 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 these reconciliations of these non-GAAP financial measures to the most directly comparable GAAP results, which can be found in today's press release or on Trupanion's Investor Relations website under the Quarterly Earnings tab.

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

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

Darryl Rawlings

Thanks, Laura.

Two months ago, we hosted our annual shareholder meeting. I'll touch on a few of the highlights today and encourage you to watch our annual meeting highlights video available on our Investor Relations website. Among the highlights shared were three key priorities. First, expansion of our adjusted operating margin. Second, deploying capital efficiently. Third, returning to free cash flow positive by Q4 of 2023.

In Q2, we saw early signs of progress in each of these areas. I'll elaborate on these now. Adjusted operating income was \$16.8 million in the quarter. After an extended period of margin compression, I'm encouraged to see margins not only stabilize, but sequentially expand. Assuming the rate of veterinary inflation remains consistent with our expectations as it did in Q2, we expect further margin expansion in the second half of the year as our pricing actions continue to take hold.

In the quarter, we deployed \$19 million to acquire over 75,000 gross new pets. I'm thrilled with the team's ability to add 23% more pets year-over-year, while deploying 6% less in acquisition spend, in my opinion, this is a strong result.

On a per pet basis, the cost to acquire a pet was 24% lower than the prior year period. Managing acquisition spend in relation to pet lifetime value is a honed skill of the team and one we will continue to refine at extremely granular levels. I'll elaborate on this point momentarily.

The combination of early margin expansion and efficiencies in our pet acquisition spend helped drive a \$3.9 million sequential improvement in free cash flow in the quarter. Additional actions taken in the quarter to reduce spend are expected to further advance us towards our goal of achieving free cash flow positive in Q4.

Overall, I'm encouraged by the progress the team has made over the past four months. This progress is evident in our results, which are once again more closely aligned with our expectations. We have more work to do, but the team is focused on executing diligently through a dynamic environment.

Long-term, our goal remains to grow adjusted operating income and deploy increasing amounts at high internal rates of return. As we manage through this near-term period of margin compression, we're throttling back on spend and allocating capital to those markets and geographies in which we are more accurately priced to our value proposition.

This decentralized approach delivered strong new pet growth in the quarter, while furthering our progress towards our margin expansion and free cash flow goals. We will maintain our granular approach as the business grows from one-to-many P&Ls, allocating capital to products, channels and geographies that deliver the highest rates of return. Understanding and managing our spend in relation to how we believe these pets will perform over their lifetime with us will be critical in doing so.

As we have discussed frequently, a pet and their corresponding lifetime value can and will vary dramatically based on the individual characteristics of that pet. That's before introducing varying levels of coverage products like Furkin and PHI Direct, our suite of offerings with Chewy and Aflac, and new markets like Continental Europe. As our mix of business evolves, our goal is to report on the internal rate of return for our new mix of pets in a more granular way.

Historically, our calculation was based on an average, assumed every new pet behaves similarly to our existing book of business. For example, it assumed pets regardless of product, channel, and geography had the same ARPU and margin profile, and with the equal retention to our existing book.

Now for many years as a mostly single line business, this was an appropriate and appropriately conservative way to talk about it. With new products, channels, and geographies becoming a more meaningful portion of new business, these assumptions have become less relevant. This is not a new concept for us. Recall, I discussed this in greater detail in this year's shareholder letter.

I further shared an example of Continental Europe, where new pet ARPU is approximately \$30 compared to that of our total book at approximately \$64. If we were to use a simple consolidated average as we previously reported, the estimated return on our spend to acquire these European pets would be overstated. This too would be the case with our newer products. If we were to assume equal retention to our existing book. Our newer products with less coverage have retention similar to what we believe the industry average retention is of approximately 30 months compared to Trupanion's over 70 months. As you've heard me say before, less coverage drives lower retention.

With this in mind, moving forward, we intend to provide increasing levels of granularity into the returns of our various products, channels, and geographies, and underlying assumptions behind those expected returns. Margi will provide some more detail momentarily.

Stepping back, I believe the changes we've made over the past several months are proving out and set us up well to deliver improved performance moving forward. We're starting to see signs of margin expansion. We are investing our capital prudently and we're making progress towards our goal of free cash flow positive in Q4. We're seeing good growth and scale in our new initiatives and through our international efforts we're meaningfully expanding our addressable market. Most importantly, our

decentralized management approach is taking hold with the team delivering stronger and more predictable results.

With that, I'll hand it over to Margi to add additional context around our quarterly performance and execution of our 60-month plan. Margi?

Margi Tooth

Thanks, Darryl. Good afternoon, everyone.

I am pleased to share the ongoing progress that has been made since our annual shareholder meeting just eight weeks ago. The team has remained disciplined in capital allocation, leaning into our most efficient channels during the quarter. This strategy enabled the delivery of yet another solid quarter of deliberate and meaningful growth while preserving our balance sheet.

We added over 75,000 gross new pets in the quarter. This is particularly strong growth when considering the intentional reduction of pet acquisition investment which was down 6% year-over-year. In the quarter, we began adjusting and in places reducing our acquisition spend to ensure we are aligning our investment to areas with the strongest lifetime value.

In geographies, where we're able to provide value to our members consistent with our brand and pricing promise. Our estimated internal rate of return was 25% in the quarter. As a reminder, we use IRR to predict the estimated future cash flows from our newly acquired pets. ARPU, retention, and adjusted operating margin are key inputs into this calculation.

In Q2, our trailing 12-month margin was 10%, which is temporarily reduced given current inflationary pressures. As you will soon hear, we've made progress on our pricing actions and are beginning to see early signs of margin expansion, a trend we expect to continue this year and into next.

Moving forward, we'll be contemplating an adjustment to our IRR calculation that we believe will more appropriately and conservatively reflect the new pet ARPU, retention, and margin contribution from each line of business and aligned to a more decentralized approach.

Recall, we talked about this more granular approach to capital allocation in our most recent shareholder letter and also at our shareholder meeting. We'll be providing this updated metric in our Q3 earnings release.

Overall, we view the returns of our new book of business is strong in the current climate. Moving forward, we will continue to use our multi-angle view when assessing our pet acquisition performance. For the quarter, we continue to benefit from our deepest mode of our vet centric approach. In today's inflationary backdrop, the conversation around Trupanion is resonating more clearly than ever before. Veterinary leads are up year-over-year, and we continue to see solid levels of conversion.

As we continue to increase the penetration of this market, we look forward to the day that our veterinary partners are freed up from financial conversations and instead are able to practice the very best medicine they studied and trained for. Ultimately, we look forward to ending economic euthanasia.

With this in mind, throughout the quarter, we maintained our focus on retention with the average Trupanion member staying with us an estimated 74 months. Given the increase in rate now flowing through consistently to our members, we are pleased with this level of retention. We believe it's a reflection of strong execution in today's environment.

Now, let me touch on our pricing efforts. In Q2, the pricing refinement and rate adjustments across North America continued with us securing additional rate in over 30 states. The average rate flowing through our book in Q2 was 16.3%. By the end of this month, we expect to have 20.8% pricing flowing through our book.

Keep in mind this rate will be immediately applied to new members and roll through the book as policies renew. By the end of September, this should increase to 22.9% and by the end of October to 23.9%, a rate we currently expect to hold through year-end.

As an example, this means renewing policies in October, we'll see a 23.9% average rate increase. This increase is relative to what these members are currently paying, which was set last October for these policies. As shared in more detail in our annual shareholder meeting, we are constantly monitoring the overall costs across the industry to ensure operating assumptions remain true.

We're pleased to report that in the second quarter growth in cost of care remains consistent with the first quarter and in line with our assumptions. Should this change, we will be poised to take additional actions as needed in the coming months.

As a result of the increased rate flow is over 60 basis points of sequential improvement toward our value proposition target during the quarter. At all times, it's our goal to return to our target value proposition of 71%. While we still have some work to do there, I am encouraged by the team's progress towards this critical target metric.

We also saw a 60 basis point sequential improvement in our subscription adjusted operating margin in the quarter. With cost of care currently increasing in line with our 15% year-over-year operating assumptions, we continue to see a path to our 15% adjusted operating margin target towards the end of next year.

While Trupanion remains the primary engine behind our performance, we continue to see solid contribution from our newer products and channels collectively. With these products ramping in market, we're making solid efficiency gains.

In Q2, Chewy expanded their comprehensive and proactive marketing campaign to introduce our insurance product line to their millions of pet parents. Following this activity, we've been pleased to see lead growth of this channel accelerate.

In addition, we continue to see increasing contribution from our European endeavors. We added approximately 4,000 new pets during the quarter and very shortly we'll be launching in Poland, adding an additional 8,000 hospitals to our addressable market, which totals over 50,000.

Demand in Continental Europe for Trupanion light product, which is known for its broad coverage and vet centric approach remains high. We're excited to bring a Trupanion product to a handful of countries in Continental Europe by year-end. Product, channel, and international market expansion are key tenants of our 60-month plan. After a period of upfront investment, many of our new initiatives are in market and beginning to contribute more meaningfully to our growth.

In the quarter, approximately 13,000 of our gross new pet adds, or about 17%, came from our new 60-month plan initiatives. Our appetite for sustainable growth in our underpenetrated market has not changed. Yet, we will maintain disciplined in our approach at all times with all products in all markets, balancing our appetite to grow the marketplace with our desire to live within our guardrails. At times, this may mean throttling back or reducing spend and prioritizing the strength of our balance sheet. We believe this is the right thing to do.

In the quarter, we took very deliberate actions to ensure we are operating as efficiently as possible across all areas of our business. The intention of this action was to reduce costs, many of which were centered around some of our long-term test initiatives that derive limited, immediate, or short-term benefit.

While many areas of the organization were able to improve efficiencies, these reductions were predominantly in fixed expenses and pet acquisition and not in areas directly responsible for supporting our members or partners.

In further support of our efforts to enhance the effective deployment of our capital, the team has made some very meaningful progress in the development of a long-awaited next generation policy administration and claims adjudication platform.

As we approach the final stages of our migration, we should see reduced capital expenditures next year. Subsequent to quarter end, we also launched our new Trupanion website designed to be more interactive and easier for members and prospective members to learn about, enroll, and engage with Trupanion.

In totality, our combined actions across pricing and capital deployment and proven ability to throttle back growth as needed, further position us to deliver a solid second half performance related to our key priorities, as well as on a goal to achieve positive free cash flow in the fourth quarter of this year.

With that, I'll hand it over to Wei to talk you through our Q2 results and outlook for the remainder of the year.

Wei Li

Thanks, Margi, and good afternoon, everyone.

It's great to speak with you all on my first earnings call as Interim CFO. Today I will share additional details around our second quarter performance, as well as provide our outlook for the third quarter and full year of 2023.

Total revenue for the quarter was \$270.6 million, up 23% year-over-year and ahead of our expectations. Within our subscription business, revenue was \$173.3 million in the quarter, up 19% year-over-year.

Total subscription pets increased 23% year-over-year to over 943,000 pets as of June 30, 2023. Calculated on a trailing 12-month basis, our average monthly retention across all of our North America's subscription products was 98.61% compared to 98.74% in the prior year period, equating to an average life of 72 months.

Unless otherwise noted, the metrics I'm sharing today are presented on a consolidated basis and it will be influenced by our mix of business, including new products, channels, and eventually geographies as Margi discussed. Our European pets are currently underwritten by third-party underwriters and are therefore not included in our per pet metrics today.

Monthly average revenue per pet for the quarter was \$64.41. This quarter and moving forward, we will also break out new pet ARPU. Average new pet ARPU for our subscription book of business in North America was \$61.49 in the quarter.

Breaking down our year-over-year subscription revenue growth of 19% for the quarter, pet growth contributed 19%, pricing increases added 10%, while mix reduced it by 9%. Lastly, foreign exchange reduced revenue growth by 1%.

Subscription business cost of paying veterinary invoices were \$133.4 million in the quarter, resulting in a loss ratio of 77%, a 60 basis point sequential improvement over the last quarter. As a percentage of subscription revenue, variable expenses were 9.7% in the quarter, down from 9.9% in the prior year period, and down from 10.1% in the prior quarter, reflecting some cost efficiencies.

Fixed expenses as a percentage of revenue were 5.1% in the quarter, up from 4.3% in the prior year period and 4.7% in the prior quarter. Fixed expenses include costs related to our new subscription products in North America and Europe. Within fixed expenses for the quarter were approximately 700,000 of one-time expenses. Absent these costs, fixed expenses as a percentage of revenue would have been largely flat quarter-over-quarter.

After the cost of paying veterinary invoices, variable expenses, and fixed expenses, we calculate our adjusted operating income. Our subscription business delivered adjusted operating income of \$14.1 million or 8.2% of subscription revenue. This is up from 7.6% in the prior quarter or approximately 60 basis points of sequential margin expansion.

Now, I'll turn to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and a different margin profile than our subscription business. Our other business revenue was \$97.3 million for the quarter, an increase of 32% year-over-year.

Adjusted operating income for the segment was \$2.6 million in the quarter. In total, adjusted operating income was \$16.8 million in Q2. This was down 19% from the prior-year period, but up 8% sequentially.

During the quarter, we deployed \$19 million to acquire over 75,000 new subscription pets, excluding the 4,000 European pets. This translated into a pet acquisition cost of \$236 per pet in the quarter. We also invested \$0.9 million in the quarter in development costs. As a percentage of revenue, development expense was 34 basis points compared to 92 basis points in the prior year period.

This step down reflects the shift of some of our new initiatives out of development and into variable, fixed, and new pet acquisition expenses within our subscription business. Adjusted EBITDA was a loss of \$3.2 million for the quarter as compared to a loss of \$1.7 million in the prior year period. Depreciation and Amortization was \$3.3 million during the quarter.

Stock-based compensation expense was \$6.5 million during the quarter, we continue to expect stock-based compensation to be around \$7 million per quarter for the remainder of the year. As a result, net loss was \$13.7 million or a loss of \$0.33 per basic and diluted share, the same as the prior year period.

In terms of cash flow, operating cash flow was negative \$3.4 million in the quarter compared to negative \$3.1 million in the prior year period. Capital expenditures totaled \$4.7 million in the quarter. As a result, free cash flow was negative \$8.1 million, a \$3.9 million improvement from the first quarter.

We expect cost actions implemented in the second quarter, along with margin expansion, to further improve our free cash flow in the second half of the year. We ended the quarter with \$236.1 million in cash and short-term investments. We maintained \$213.1 million of capital surplus at our insurance subsidiaries, which was \$57.3 million more than estimated risk-based capital requirement of \$155.8 million. Outside of these insurance entities, we held \$25.4 million in cash and short-term investments at the end of the quarter, with an additional \$40 million available under our credit facility.

I will now turn to our outlook. For the full year of 2023, we're increasing our guidance at the midpoint for both revenue and adjusted operating income. Revenue is now expected to be in the range of \$1.73 billion

to \$1.89 billion, representing 19% growth at the midpoint. Subscription revenue is now expected to be in the range of \$708 million to \$718 million, which would represent 20% year-over-year growth at the midpoint.

Total adjusted operating income is now expected to be in the range of \$70 million to \$80 million. At the midpoint of the range, this continues to imply expansion in adjusted operating margin in the second half of the year as our pricing actions flow more meaningfully through our book of business. For the third quarter of 2023, total revenue is expected to be in the range of \$270 million to \$275 million.

Subscription revenue is expected to be in the range of \$180 million to \$182 million. Total adjusted operating income is expected to be in the range of \$18 million to \$21 million. As a reminder, our revenue projections are subject to conversion rate fluctuations predominantly between the U.S. and Canadian currencies. For the third quarter and full year 2023 guidance, we used a 75% conversion rate in our projections, which was the approximate rate at the end of June.

Thank you for your time today. I will now hand the call back over to Darryl.

Darryl Rawlings

Thanks, Wei.

Before we open it up for questions, I wanted to remind you of our annual shareholder meeting highlight reel available on our IR website. In addition, we will be in attendance at several upcoming investor events. Margi will be attending the Canaccord Genuity Annual Growth Conference in Boston next week. Next month, we will be in attendance at Lake Street's BIG7 Conference in New York and the Jefferies Virtual Pet & Wellness Conference. We hope to speak to many of you there.

We'll now open it up for questions.

Operator

(Operator Instructions) The first question comes from Maria Ripps from Canaccord. Please go ahead.

Maria Ripps

Great. Thanks so much for taking my questions. First, can you maybe update us on your more recent progress in California with rate increases up to you sort of received the approval there. What's the latest timeline around refiling? Is there anything different that you're doing in terms of how you approach the filing process this time either in terms of the data that you're presenting to the regulators or anything else? Then I have a quick follow-up.

Margi Tooth

Hi, Maria. It's Margi. Yes. Overall, we are pleased with the progress in California during the quarter, we did get our second approval within eight months. We've had two in the last eight months; the stacked rate approval is going to approximately 21%. In terms of the 13% rate that was approved in June that was based on data in November 2022. Specifically, to answer your question about a different approach, what we're doing now. Once we have that second approval through and live in market, which will be effective from next week, we'll then start working with them again on the next filing, which we're really kind of go into the specifics related to the data that we saw coming through in Q1 and Q2 of 2023. The last six months effectively, we'll be able to bake into this new filing and we'll work with them to dig into the trends

we're seeing specific to California and help to better articulate the need for the rate that we have there in the state.

Overall, I think it's a big step forward in fixing our loss ratio. We now can increase our addressable market in the State of California, where we have more neighborhoods, which we can reignite growth in, and we will continue to dig into approach on lifetime pricing in California to speak that additional rate in the near future. It's a collaborative relationship and looking forward to that next step.

Maria Ripps

Got it. That's very helpful. You mentioned 16% adjusted OI target towards the end of next year. Assuming inflation sort of remains consistent with your expectations, is this predicated on another round of approvals from a handful of larger states, or do you feel like you have enough approvals under your belt?

Margi Tooth

Right. By the end of this year, we'll have about 23% will be flowing close to 24%. Essentially, what that means is we will have state approvals to hold that rate at the end of the year. We're not going to continue to go above that rate and going in for more approval to expand it. What we are doing though is monitoring that cost of goods and it's true to say that if that 15% inflation holds, we will continue to see that 24% flow through into next year, which will allow us to catch up on the 15%. If we're getting a higher rate than 15%, you start to see that margin expansion. This month just gone, we had 16.3% rate flowing through our book, which is why you saw that margin expansion. As you mentioned, if that assumption holds true and we don't see a change in the 15%, we believe that we will have sufficient rate and plans in place to get us on track by the end of next year. We will keep monitoring it, if things change then we will adjust our approach, but we feel confident right now that we have the right plan in place to get that.

Maria Ripps

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

Margi Tooth

Thank you.

Operator

The next question comes from Shweta Khajuria from Evercore ISI. Please go ahead.

Shweta Khajuria

Thank you for taking my questions. If the California rate filing, if it does not get approved or if the approval is once again lower than what you are—what you expect to file for, could you talk about what the alternative is at that point and then—and/or the impact on the overall book of business. Then I have a follow-up, please.

Margi Tooth

Yes. Hi, Shweta. For the California rate filing right now, what the latest filing the site rate has allowed us to do as I just mentioned is really go a little bit further into California than we have been. We very deliberately pulled back our spend. We're looking at where we have strong margin. In areas where we didn't have strong margin and we weren't hitting our target value proposition, we were giving greater than

our target value proposition, we really started to pull back that growth. We've been able to dig in further into California and get a little bit of that growth moving in other areas. If we do see an extended delay on the next rate approval, we'll continue to monitor where we are effective and where we have the strong margin and we will adjust our operating approach in terms of growth strategy, depending on where that rate is.

This is something that we—as we look at this in a more granular level as we started to really look about decentralized approach to management, this is something that we should be expecting to do more and more as we really kind of kick into our decentralized approach just in terms of distribution strategies, different products, different geographies. While California is one part of our business, it's not the biggest part of our business, and that's very deliberate as we thought about distribution moving forward to the long-term. We will calibrate, we'll keep checking the data and making sure that we have the right value proposition, and we'll adjust as necessary. Right now, as I mentioned, we feel very positive about the relationship with the regulator, and we're encouraged by the dialog, and we'll continue to work with them to do what's right for our members in the State of California.

Shweta Khajuria

Okay. Thank you. You mentioned that you pulled back on some of the initiatives that were maybe for the mid to long-term or you weren't seeing the returns as expected as part of your cost savings or cost cutting. Could you talk about which one specifically those were?

Margi Tooth

Yes, it's really across the board. There are some things that we do that ultimately will help us unlock a few tests. Whenever we look at deploying capital, we try and learn new ways of doing things, new avenues, new tests, new tactics, as well as, I would say, for some channels, building things out for the future. They're related to whether it's a vet, whether it's breeder, social media, the things that we're doing in partnership with people, and also having teams that are testing new things. It's about leveraging as much as we can within the existing team set that we have today and ensuring that the things we're doing deliver return today rather than a tactic that is a test, that's not necessarily proven or maybe even driving the results we wanted.

We've been a little bit more stringent in the quarter around that and pulling back, so we can be very deliberate with the deployment of capital. It doesn't harm our core channels, we stayed very true to the vet channel. The vet channel was holding very strong in the quarter, which is testament to the impact of the product that we have, and it just allows us really to focus and double down on things that we know will drive immediate results and how this being more discipline with our capital deployment. Overall, as Darryl mentioned in his opening remarks, we got 23% more pets with 6% less investments. I think in terms of deployments, we're still being very disciplined and will continue to be as disciplined with distribution and growth moving forward.

Shweta Khajuria

Okay. Thanks, Margi.

Margi Tooth

Thank you.

Operator

The next question comes from Josh Shanker from Bank of America. Please go ahead.

Josh Shanker

Yes. Thank you very much. Good afternoon. In terms of thinking about maybe taking California out of the picture for a second, what percentage of your business is rate adequate, where you've gotten enough approvals, or the states did not require approval such that you feel very comfortable going forward in?

Darryl Rawlings

Hi, Josh. This is Darryl. It's a very good question. When we look at our total new pets that have come in, we're really breaking the business down into multiple P&Ls. Our historic subscription business, if you took North America, we break it into about three different markets. Two of those markets, the average new ARPU is about \$74, \$75 and the other two markets, the average ARPU is about \$56. You could see that there is a dramatic difference. The area where we have the lower ARPU, about \$56, is priced adequately to our value proposition today and is actually the areas with the higher ARPU that we have had more margin compression over the last six to nine months.

In addition to that, when you look at the new products that we have, which represented about 17% of our total new pets in the quarter. Most of those are pretty adequately priced for. The biggest challenge for us is in some of our core subscription products in some of the more expensive areas in the country, and that's where Margi and the team have slowed the growth there. As we've had the approvals, like, we've been receiving the opening remarks, we've had 30 state approvals in the last quarter. Now we're able to put our foot back more on the gas, because we're adequately priced.

It's something you always have to monitor, but you need to monitor in a very granular way across products, distribution channels, not just by the state, but down to the neighborhood level. For the team to be able to take your average pet acquisition cost of \$309 and lower it down to \$230 in a single year, I think it's a testament to the team and pointing the spend in the right direction, feel really good about the progress.

Josh Shanker

Thanks for that answer. I don't need specific numbers, I don't think you had given them anyway, but when I look at the retention dipping a little bit, obviously, it should be expected as you raise prices. Is the movement coming into the first years, is it coming in those receiving 20% or greater rate increases, or is it in the majority of the book? I guess that 80% of book that's neither first year nor getting a 20% rate increase.

Darryl Rawlings

It's interesting, because that slight dip in retention, which as a reminder still well over 70 months and over double what we think the industry average, that includes our new initiatives. It includes the new products that have lower coverage, new distribution channel. If you pulled those loans out, I think the retention rate would be very similar to what our average has been in the last couple of years. It remains very strong. It's pretty consistent and there are three buckets that we talked about in our shareholder letters between first year average rate increases and those that have higher. Nothing dramatic to change there. Margi, do you have anything to add there?

Margi Tooth

I think you're right, what we did see, we saw a very strong start in Q2 retention as we get more and more rate, frankly, the book of business. It is our expectation that we see a little bit of a softness coming through. We saw a little bit about the end of the quarter, but generally, we feel like the retention has been very strong. I think the team has done a very good job in terms of execution and making sure that value proposition is well understood. They have a very robust plan in place for the remainder of the year, acknowledging that that rate increase will continue to tick up through the rest of 2023 and into '24.

So far, we feel confident in the way that they are managing that process and we'll keep monitoring in those buckets it's all (inaudible) and there's a lot more granular detail behind the scenes. The retention metrics that we shared in terms of the 72 months with the overall book of business. What you have in there is a real mixture, as Darryl mentioned, of products, of channels. We see a very different retention experience for the newer products and very different retention experience in different geographies as well. As we see those starting to tick up over that 17% that we mentioned earlier, you're going to see a difference in that retention profile too, but so far so good and we feel like it's in a good place.

Josh Shanker

Thank you very much for the answers.

Operator

The next question comes from Jon Block from Stifel. Please go ahead.

Jon Block

Great. Thanks, guys. Good afternoon. First question, can you just talk about the path back for the subscriber MLR. I think it came down 60 bps Q-over-Q, which was good to see, but it's still pretty darn elevated at 77%. You've got some of the Southern California and New York. How should we think about that trend line, call it, into the back half of 2H 2023—the back part of 2023 and even into 2024. Do you want to give a little bit more specifics on when you think you can get back to that 71% target?

Margi Tooth

Yes. Sure. When we think about the—we're happy to see that margin expansion. I think it's back to a little bit more about predictability that we have known and loved over the last 20 plus years. In terms of the rate that we have flowing through at this 16% by the end of Q2, we've got that continuing to increase through this year. You can expect with that rate that margin starts to expand even further and brings us closer to our value proposition.

Still confident with that in mind, we continue to see the 15% increase of inflation across the book of business. If that continues, then by the end of next year, we expect to be back towards target. If it changes, and obviously, that will change, we'll adjust accordingly. But we feel confident with the plans we have in place and the rates we have flowing through, combined with our retention, that we will see that happen in the back end of '24.

Jon Block

Okay. Maybe just ask it differently. Is there a certain trend line that you need into the back part of this year more in order to hit your free cash flow positive target?

Margi Tooth

Yes. For our free cash flow positive, as Wei mentioned, we've seen some good improvement sequentially quarter-over-quarter. I think \$3.9 million benefit in terms of where we are right now in terms of cash. I think in terms of the expectation for the year-end, we still fully expect with the rate we have flowing, that we're making good progress in Q3 and Q4 is still very much on track in terms of our goal.

Jon Block

Okay. Thanks for that. Maybe the second question might have a couple of parts. First just from an employee perspective. I thought we mentioned some one-time expenses, I don't know if it was 700k or 900k, was that severance if it was or if it wasn't. Darryl, can you talk about the employee count at Trupanion if that's being curtailed, and if so, where the company is making some of those changes?

A follow-up on a different topic, it's just more of a clarification, I think, Darryl, you said, hey, retention is getting hit a little bit from some of those lower-end plans, if you normalize for that, retention would be largely unchanged. But just to be clear, your PAC is also benefiting from that, right? You're saying how—you've done a great job on PAC but those lower-end plans, I believe, have a lower pet acquisition cost. I just want to make sure that would be showing up in both places right to be hitting your retention but benefiting your PAC arguably. Thanks, guys.

Darryl Rawlings

Yes. Margi can answer probably—we got an echo there. The question on—sorry, that was me on my end. I'm sorry. There was 3% reduction in headcount across the Company during Q2. There was some severance expense. Margi alluded that in her opening remarks. The second part of it is, yes, just as a reminder, our pet cost was reduced by 6% and yet we had 23% more pets that we enrolled during the quarter, but all pets are not created equally. Some of these pets have low ARPU and lower retention, other ones have higher ARPU and higher retention. It's very important that we look at it in a decentralized way and spend the corresponding amount. When you see the pet acquisition cost drop is as dramatically as you did from 309 to 230, it's an evidence that we're doing that.

Operator

The next question comes from Wilma Burdis from Raymond James. Please go ahead.

Wilma Burdis

Hi. Good evening. Maybe you could give us a little bit of color on the time period for the other business to roll off. I know it has a little bit shorter retention than the (inaudible) business. From what I'm looking at it seems like maybe starting in 2024 that would roll off over a period of three to five years. Maybe just let me know if that makes some sense.

Wei Li

Hi. This is Wei. I can answer this question. Basically, it's in the prepared remarks, I gave the new guidance of the Q3 and the full-year guidance for total revenue and the subscription revenue implies also for Q3 and Q4 for other business. We have been seeing the growth has been decelerating, but still the pace of rolling off of our book, it seems slower than we had expected. We're still expecting growth versus last year in the second half of this year.

Looking at 2024, there's a lot of uncertainty, but we believe will start to decline, but our model right now single digits of revenue decline for other business. As a reminder, the other business margin is usually between 2% and 3%. We do think, given the new arrangement with PASPAC, it will be about 3% going

forward but it's still much smaller than our subscription business. The revenue projection, I would say, wouldn't impact too much of our bottom-line performance. I would say in terms of out years after 2024, I would say it's going to be a pretty long tail based our experienced before. Also, as a reminder, if they were off quicker than we expected, there will be more capital effective to our capital position.

Wilma Burdis

Thank you. I guess maybe the single-digit revenue decline would continue for 2025 and beyond. Is that how I should interpret what you said?

Wei Li

That's for 2024. I'll be honest, we haven't really started 2025 for this other business. I do not have too much clarity on that, but I would say it's going to be fairly slow decline over the next three to five years.

Margi Tooth

Yes. If I can just add as well. Wilma, hi, it's Margi. Just to echo as Wei was saying, we're expecting to be single-digit growth. We want to be good partners; we want to make sure that from another business perspective that we're able to support the businesses and partners that came to us and support them anyway in the first place. The roll off, obviously, is dependent on their funds and we'll be here to support them. The main thing for us is ensuring that we have sufficient benefit from that partnership in terms of the margin, which, as Wei alluded, is certainly increased. We look forward to seeing that be part of our business for little longer than we anticipated. It has upside for everybody, and we will continue to share changes as and when they happen.

Wilma Burdis

Okay. Then one quick one. We noticed that you broke out a new line item over the last few quarters. Pet acquisition expense for commission-based policy, that was about \$900 million this quarter. Could you just give a little bit of clarity on what that is and is that netted out of the pet acquisition cost of \$236 or how should we think about that figure?

Wei Li

Yes. Good question. As a reminder, we acquired Pet Expert and Smart Paws, the second half of last year. Since then, when we report our quarterly results in the key metrics, the total pet count and the subscription business pet count, they do include those (inaudible) load in Europe. As a reminder, they are currently under a commission-based insurance agent business model. We do not underwrite those policies; it's underwritten by a third-party policy, their revenue are commission. That's why, if you look at the report that we provide every quarter since then, the per pet metrics, especially those do not include the European pets underwritten by third parties. That's the reason when we do the reconciliation to calculate the pet acquisition cost for every average single pet, the \$236 per pet this quarter, that has to be excluded, because it doesn't make sense. The revenue profile is totally different, our underwriting model. I hope that's helpful.

Wilma Burdis

Thank you.

Operator

The next question comes from Katie Sakys from Autonomous Research. Please go ahead.

Katie Sakys

Hi, thank you. It looks like quite a bit more cash moved into the insurance subsidiaries this quarter. Two months ago, at the shareholder meeting, it sounded like you guys felt that the subs were more than adequately capitalized. I'm kind of curious why the move, why the increase well above minimum RBC requirements.

Wei Li

Hi Katie, this is Wei. I'm happy to answer this question. I'll let Darryl and Margi chime in. Basically, we wanted to provide a little bit more clarity about our cash position. I wanted to reiterate what I mentioned before is that we're very happy about our cash position. I'm increasingly confident about the trajectory. The free cash flow has been improving \$4 million-ish better than Q1 and we expect to continue to improve sequentially in the second half of the year. I'm confident about our free cash flow being positive in Q4. We do provide a little bit more color on the cash position between the insurance company and the holding company just for being more transparent. As you can see, we have \$25 million in cash at the outside of the insurance entity, and we also have \$40 million credit facility, and plus we have \$57 million more than the required capital requirement at the insurance company. That gives us over \$120 million that we believe is we're appropriately capitalized in the near future.

Margi Tooth

Yes. If I can add a little bit there as well. Hi Katie, it's Margi. In terms of why there is additional, you're right. We are overcapitalized and we are actively working on addressing that to ensure that that—the good news is that we don't need to continue to put money in when we've already got capitalization at a level that we have. Historically, we would have to continue to support that. Hopefully, you can hear me. There are some blue angels flying over our heads right now, I apologize for the background noise. Our hope is over the next few months, we will work through our plans in terms of what that capital allocation looks like so we can ensure that we are as efficient as possible. We're just happy that at this stage we are absolutely well above that RBC level, which means that we're not continuing to have to put money in at the levels we were when we had that combined growth of both the Trupanion and our other business segment growing at much higher levels than before.

Katie Sakys

Okay. As a quick follow-up question, how much of your marketing expense in 2Q, would you characterize as cuttable. I know you guys talked about doing some experimental things on the marketing side? How much of that could potentially be cut, if need be, in the back half of the year to get margins where you'd like them to be?

Margi Tooth

Yes. When we're thinking about marketing, if we're talking about the core business specifically here. There have been some reductions already in Q2 that really will take us to the point where we're looking at our core channels. We can continue to go further into our PAC, we're always looking at the internal rates of return. The key thing here is, as Wei alluded in the opening remarks, we're really trying to get granular and decentralized in the way we're reporting our internal rates of return to allow us to understand what do we need to be spending for a specific area or geography or product, versus what have we just historically got on the books. For example, when we talk about cutting expense that would imply that we're not going to be—there are things that we're doing that are not going to drive return at any point in time.

We've already reduced—we go to things like contract spend, we've made sure that the teams are clear on the value being driven and driven from the activities they're producing. We could take that PAC down probably somewhere between 25% to 30% further than we have done. It's important though for us if we've got margins where they need to be, we're not looking at that blanket approach, we're looking at a granular level approach. We can see there are lots of areas within our addressable market across North America that we can very healthily grow and that's a lot of the growth that you've seen in the quarter has come from areas where we have strong margin or we are hitting our value proposition, and we have confidence in the internal rates of return to continue to grow that.

We didn't act as quickly as we could have in the quarter. I think we spend a little bit of money in places that we probably shouldn't, and we didn't invest enough in areas where we could have. I think what you'll see in Q3 is further refinement. That being said, 6% reduction in PAC and 23% growth. Seeing that distribution strategy really kick in, it's taking hold from a perspective of what we said we would do, we would have more opportunities for growth in areas that we had not had before, whether that's new products or new market. That allows us to test new strategies and operate at a slightly lower level from a PAC spend so we're not all putting everything into our core business. It can be through other products, other geographies to bring that PAC, sorry to bring the IRR within its guardrails. We have flexibility. We are fortunately able to leverage our distribution strategy, which is really doing exactly what we intended it to do. We feel good about the direction that's moving through the year, especially as we see margin expansion, and it gives us a lot more appetite for growth as we can see an end to the margin compression that we've had so far this year.

Darryl Rawlings

Yes. I'll just add one last thing. This is about smart disciplined growth and being free cash flow positive in Q4. Those are our goals. That's what we're executing towards.

Katie Sakys

Got it. Thank you.

Operator

The next question comes from John Barnidge from Piper Sandler. Please go ahead.

John Barnidge

Thank you, very much, and good afternoon. My question—and congrats on the approvals on the rate filings—is with ARPU becoming a changing dynamic, how should we think about the significant 20% pricing and individual receiving it and then toggle and with the deductible to keep their subscription payment unchanged. Is that an increase in frequency at all?

Margi Tooth

No, it's not actually. It's been consistent. It's something that we watch, and we expected to see that come up. Since we've been putting these rates through, we haven't seen that change. It's been consistent for the last 10 or so years. What is changing though, is as we've mentioned over the last few quarters, we are seeing a different mix of businesses where we're acquiring pets. When we talk about mix, we're talking about geography, we're talking about age of pets, we're talking about breed, even species. That's driving some of the shift in terms of the ARPU that we ultimately end up netting.

In terms of the rate increases and how we should think about the impact on the members. Often what's happening is there may be a phone call into the team, but the team, we speak to all our members if they are looking to cancel, they're able to really explain the value proposition. That experience hasn't changed either. We're seeing strong retention. We're seeing no increase in the number of people that are, what we call by down (inaudible) that deductible around. Ultimately, where we're trying to get to now is making sure that we are proactively reaching out to members to help them understand what's happening with vet industry, so that they can understand why these prices moving.

I think ARPU, like I mentioned, is really largely coming through that mix of business. As Darryl mentioned earlier in the call, we have such a difference across North America with ARPU, we've got two areas in North America that have ARPU in excess of \$74, that equated to 40% up on new business. Then you've got 50% of our new business coming from areas where we have a \$55 ARPU. When you look at those two together, you really do have a blend. That blended ARPU doesn't tell the full story, which is really why we want to go to next page, next quarter, to be able to break that down and give us far more granular approach to how we're thinking about growth and how ARPU is one component of that internal rates of return.

I think in terms of the pricing, the good thing is we have got our margin expansion, which is what we were looking for and we'll continue to see that come through assuming that cost of goods which will then show up in those numbers from the ARPU growth, we're expecting by year-end. Does that answer your question, John?

John Barnidge

Yes, it does. Thank you very much. You talked maybe about considering semi-annual renewals at your Investor Day, is that still under consideration?

Margi Tooth

Absolutely. I think we're always open to adjusting to make sure we can give our members the best experience and that's what that's in regard to. Ensuring that there is a way for our members to accurately budget for the cost of care. Now that budgeting, often for the 97% of the population that's uninsured, comes through really leaning into the credit card savings, friends, whatever they can do to afford the cost of care. Those 3% that are insured and those are insured Trupanion, up until recently have been able to budget, because they've had a monthly payment that's pretty consistent year-over-year.

This year is a little different. It's different for every insurance provider. It's different for the industry, where we are seeing bigger increases and we feel it's more appropriate and fair to be able to slowly move into those increases rather than giving people a 20% plus increase. Adjustments to our product to always front of mind. We believe we have the best product in the industry, which is why our retention rates are the strongest that they are, less coverage, lower retention. We have very, very high coverage and higher retention. I think adjustments such as renewal dates and making tweaks to that process through the period of renewal is important to us. We'll continue looking at that. There is nothing right now in market that we're doing towards that goal, but that will be something that we'll plan over the next year.

John Barnidge

Great. Thank you very much.

Margi Tooth

Thank you.

Operator

Due to the time, this concludes our question-and-answer session. The conference has now concluded. Thank you for attending today's presentation. You may now disconnect.