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Trupanion, Inc.

Third Quarter 2023 Earnings Conference Call

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CORPORATE PARTICIPANTS

Laura Bainbridge, *Senior Vice President of Corporate Communications*

Darryl Rawlings, *Chief Executive Officer and Chair of Board*

Margi Tooth, *President*

Wei Li, *Corporate Controller and SVP of Finance*

Fawwad Qureshi, *Chief Financial Officer*

CONFERENCE CALL PARTICIPANTS

Maria Ripps, *Canaccord*

Shweta Khajuria, *Evercore ISI*

Joshua Shanker, *Bank of America*

Jonathan Block, *Stifel*

Wilma Burdis, *Raymond James*

Katie Sakys, *Autonomous Research*

John Barnidge, *Piper Sandler*

PRESENTATION

Operator

Hello, and welcome to the Trupanion Third Quarter 2023 Earnings Conference Call.

(Operator Instructions) Please note, this event is being recorded.

I would like now to turn the conference over to Laura Bainbridge, Senior Vice President of Corporate Communications. Please go ahead.

Laura Bainbridge

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

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Participating on today's call are Darryl Rawlings, Chief Executive Officer and Chair of the Board, Margi Tooth, President, Wei Li, Corporate Controller and SVP of Finance, and Fawwad Qureshi, Trupanion's Chief Financial Officer.

For ease of reference, we've included a slide presentation to accompany today's discussion, which is available on today's webcast.

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 it over to Darryl.

Darryl Rawlings

Thank you, Laura.

I'm happy with the sequential progress within our key financial metrics in the third quarter. The recent improvements are direct reflection of the team's execution and Margi's leadership over the past seven months. For the benefit of what appears to me to be an increasing number of new people interested in our story, our goal is to earn a 15% profit margin from our existing clients. With these pre-tax funds, we can choose to reinvest in our growing business in our large and underpenetrated market by adding new pets or alternatively pay dividends or repurchase shares after taxes. We refer to this profit margin as our adjusted operating income. The primary drivers of our adjusted operating income are the monthly revenues we collect from our subscription members, minus the costs we incur to pay veterinary invoices on their behalf, and to a lesser degree, our variable and fixed expenses we need to operate our business.

In our 23-year history, the cost of veterinary invoices, or our measure of veterinary inflation has grown consistently in the range of 5% to 6% per year. Our historical track record of pricing to these levels of inflation was equally consistent, delivering within a percent or two of our 71% target value proposition year-after-year. Coming out of COVID in 2022, the cost of veterinary care began to quickly accelerate. Within a period of less than 10 months, veterinary inflation increased an additional 900 basis points over historical

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norms. While this rapid rise in the cost of veterinary care was unprecedented in 50 plus years, at Trupanion, we were slower to react than I would have liked. The extra 900 basis points of inflation had a material impact. Adding to this challenge, our current policy terms means it takes us 12 months to 18 months to reprice our existing members.

In 2020 and 2021, our annual adjusted operating margin for our core subscription business was 13.9% and 14.3%, respectively. After this rapid change in veterinary inflation, this same margin compressed sequentially four consecutive quarters until we hit a low of 7.6% in Q1 of this year. Compared to 2021, this was a 670 basis point compression to our margin to our core business and it should go without saying, made operations more challenging. Today's slide presentation includes these details.

Over the past seven months, the team has executed well against our mandate of restoring our target margins. We are managing the business on a much more granular basis, empowering our team through a more decentralized operating structure and making tough but necessary decisions to improve our overall operating efficiency. The actions taken were deliberate and meaningful and in the quarter translated into what I believe is a significant sequential improvement in our adjusted operating margin and free cash flow. We have work still to do in getting back to our long-term margin targets, but I am encouraged by our progress.

With that as a backdrop, I'll hit the key financial highlights for Q3. Total revenue was up 22% year-over-year marking our 39th consecutive quarter of 20% plus revenue growth since going public in 2014. Adjusted operating income was $24 million in the quarter. This is up over 40% sequentially over Q2. Free cash flow was $7 million, an improvement of approximately $15 million from our Q2 results. Seven million positive free cash flow equates to approximately 2.5% of total revenue.

It is our current expectation we will target at or around this baseline of positive free cash flow on an annual basis to avoid dilution or additional debt while we continue our growth in this large and underpenetrated market for the years and decades to come.

With that, I'm going to turn it over to Margi to provide more details about the actions taken and this quarter's accomplishments. Margi?

Margi Tooth

Thank you, Darryl, and hello, everyone.

To reiterate, revenue growth was a strong 22% year-over-year with our subscription business the primary driver behind our performance. Total subscription pets including European pets were up 20% year-over-year. Average revenue per pet, which does not currently include our European book of business was up 3.2%. Please keep in mind that unless otherwise noted, our per pet metrics are reported on a blended basis and will increasingly reflect mix of business. For example, the year-over-year increase in ARPU for the average Trupanion member was higher than the blended average, increasing 4.3% year-over-year.

Since inflationary pressures kicked in over 12 months ago and accelerated at an unprecedented rate, the team has been hard at work taking pricing actions that will put us ahead of the rising costs of care. I am very pleased to see the output of their efforts and the rate flow we are now starting to experience. During the quarter, we had an estimated 20% price adjustment flowing through the book. Our pricing power with existing and target members remains high. Across our blended book of business, which as a reminder is a combination of all North American products within our subscription model, the average subscription pet stayed with us 69 months, reflecting the impact of new products and mix of business. Isolating retention to our Trupanion branded business, the average life of a Trupanion member was 72 months, more than double

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that of the industry average. We believe this is a good result against the backdrop of our pricing actions in the quarter.

We're seeing highly favorable effects of our pricing increases, outweighing impact on customer retention and anticipate this will continue to be the case as we progress through the remainder of this year. As a point of comparison, the lifetime value of Trupanion members was an estimated 25% higher in quarter three than in quarter two. This was driven by $2 increase in ARPU and an approximate 2% improvement in profit margin, partially offset by a 4 basis point dip in retention. This positive result notwithstanding, we remain laser focused in our efforts around member retention and service levels. Additionally, we also began to realize benefits from actions taken earlier in the year to improve efficiency in our operating expenses throughout the quarter.

When combined with the improvement towards our value proposition, subscription adjusted operating margin expanded 190 basis points to over 10% in the quarter. With pricing actions flowing through our book and assuming cost of care increases remain consistent, we continuing as anticipated towards our 15% margin target by the end of next year.

I'll reiterate that in our large and underpenetrated market, we prioritize growing adjusted operating income or the funds available to us to invest in growth. More funds means we're able to help more pets and support more pet parents. We continue to identify opportunities to invest these funds at our high internal rates of return of 30% to 40% measured on an extremely granular level.

Here is more context. In the quarter, adjusted operating income was $23.8 million, up over 40% over Q2. We made the deliberate decision to deploy $16 million of this and acquired approximately 71,000 pets with this investment. Compared to the prior year period, this represents virtually the same number of pets added with 20% less spend. Against the backdrop of a rising cost of care, the veterinary channel continues to prove highly efficient. Despite the reduction in pet acquisition spend, veterinary leads were up in the quarter and continue to comprise the majority of our leads. We believe this metric reflects the urgency with which veterinarians can speak to the benefits of high quality medical insurance. Encouragingly, conversion in the veterinary channel also remains strong. This lead in conversion performance are leading indicators of our pricing power within our target market.

Turning to our newer distribution channels, we also saw strong continued contribution from both our new products and geographies. In the quarter, nearly 19% of our new pets came from these new initiatives. As discussed last quarter, given the increasing contribution from our new initiatives, moving forwards, we'll be breaking out growth metrics related to key areas of growth by our core Trupanion branded product in North America, our new products all in North America, but not primarily branded as Trupanion, and our international geographies. Not only do we believe this better aligns with our decentralized approach to execution, it provides a new level of transparency to our growth metrics and the overall performance of the business.

As our business continues to expand, blending all metrics into one no longer provides a fair measurement of impact and returns on dollars invested. For ease of reference, we've included the details in today's slide presentation. Note, across our P&Ls, we're updating our IRR methodology to be more reflective of our expectations of how these new pets will perform over their life with us by segment. We will also continue to report IRR under our prior methodology for a period of time.

Within our core Trupanion branded business, we spent just over $14 million to add approximately 57,300 new pets in the quarter at an average new pet ARPU of $66.26. We assume these pets will stay with Trupanion for a period of 76 months, consistent with our three year average, and deliver an adjusted operating margin over their life of 12%, which today we believe to be the most appropriate assumption. This is also in line with our three year average, but below our long-term goal of 15%.

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Combined, this results in an average lifetime value of $616 for new pets enrolled with Trupanion in the quarter, the average cost to acquire these pets was $229, which translates into an estimated internal rate of return of 42% outside of our growth guardrails of 30% to 40%.

Turning to our new North American products, a varied collection of products not primarily branded Trupanion, the metrics are materially different, and given the increasing size of these products, they impact our overall mix more significantly than before. For example, of the 9,400 new pets we added this quarter, the average new pet ARPU was $37.83. Today, these pets stay with us on average for 17 months. Similar to Trupanion's core product in the early years, these products have not yet reached operating scale, resulting in a negative adjusted operating margin. On a per pet basis, the cost to acquire these pets was $111. This is below the internal rate of return we would typically target, and for this reason, we only spent $1 million in the quarter, or about 6% of our total pack spend here.

Long-term, it's our goal to operate these products at a 15% adjusted operating margin and within our 30% to 40% internal rate of return guardrails, and we remain confident we can get there. Until then, however, we expect to maintain relatively low levels of spend in this area.

In Europe, we spent roughly $800,000 to add approximately 3,900 new pets in the quarter. Today, these products are not fully underwritten by Trupanion. Long-term, however, it is our intention to underwrite our European businesses, including actively selling a Trupanion light product. It is our goal to operate this business at our target 15% adjusted operating margin and deploy capital at a 30% to 40% internal rate of return. Keep in mind, however, that the ARPU of these pets and thus the lifetime value and target acquisition spend will be very different to that of our existing book.

For example, the average pet owner enrolling in Europe today is paying $25 per month. If we were to assume these pets stay with us for a period of 74 months and deliver an adjusted operating margin of 12%, both consistent with our three year average, we could spend approximately $95 per pet to earn a lifetime value of $226, resulting in an estimated internal rate of return in line with our target.

Overall, we view these returns on our new book of business as strong. By breaking down these results in a more granular level as we have done today, we can dive deeper into our mix of business experience, which as you can now see can and will vary dramatically depending on product types and geographies. Looking ahead, we will continue to be disciplined in our approach to growth, allocating capital prudently, prioritizing margin expansion, and driving efficiencies in our expense structure. Over the past several quarters, we've taken deliberate and meaningful action in each of these areas which help propel us to free cash flow positive in the quarter. With a baseline of modest positive free cash flow established, we intend to stay that way, building on our track record of flexing our operating levers to hit our business objectives.

This achievement is a testament to the dedication and focus of our team, and it sets a solid foundation for our financial stability moving forward. The health of the veterinary profession remains critical to our success. Veterinarians and their staff continue to grapple with increasing inflationary pressures and structural challenges affecting the delivery of high levels of care. As a reminder, our cost plus model is deliberately designed to be a solution to these financial pressures. Supporting veterinarians and their teams remains at the heart of what we do.

In a moment, I'm going to hand the call over to Wei to discuss our third quarter results in greater detail. But before I do so, I want to thank him for stepping up over the past year. It has been a pleasure to partner with you, Wei, and you've been a tremendous leader to the team. We appreciate all you've done and look forward to your continued contributions across the business.

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I also want to officially welcome Fawwad, it's fantastic to have you on the team, and I look forward to working closely alongside you. Already, you have proven yourself to be a great addition to Trupanion.

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

Wei Li

Thanks, Margi, and good afternoon, everyone.

Today, I will share additional details around our third quarter performance as well as provide our outlook for the fourth quarter and full year of 2023.

Total revenue for the quarter was $285.9 million, up 22% year-over-year. Within our subscription business, revenue was $182.9 million in the quarter, up 20% year-over-year and ahead of our expectations. Total subscription pets increased 20% year-over-year to over 969,000 pets as of September 30, 2023. This includes approximately 38,000 pets in Europe, which are currently underwritten by third party underwriters. Monthly average revenue per pet for the quarter was $65.82, up 3.2% over the prior year period. As a reminder, this is inclusive of all North American subscription products and will reflect mix of business.

Highlighting this mix, average new pet ARPU for these products was $62.25 in the quarter. Breaking down our year-over-year subscription revenue growth of 20% for the quarter, 18% of this growth was driven by our core Trupanion branded business. Specifically, pet growth contributed 14%. Pricing increases added 13%, while mix reduced it by 8%, lastly, foreign exchange reduced its revenue growth by 1%. Additionally, our new products in North America contributed 1% revenue growth with the remainder coming from Europe.

Subscription business cost of paying veterinary invoices was $138.9 million in the quarter, resulting in a value proposition of 75.9%, a 110 basis point sequential improvement towards our target over the last quarter. As a percentage of subscription revenue, variable expenses were 9.5% in the quarter, down from 9.7% in the prior year and prior quarter periods, reflecting cost efficiencies.

Fixed expenses as a percentage of revenue were 4.4% in the quarter, up slightly from 4% in the prior year period, reflecting the shift of pre-revenue initiatives out of development and into fixed expenses, but down from 5.1% in Q2. 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 $18.5 million, or 10.1% of subscription revenue. This is up from 8.2% in the prior quarter or approximately 190 basis points of sequential margin expansion. This reflects 110 basis point reduction in veterinary invoice expense and 80 basis points of scale in variable and fixed expenses.

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 $102.9 million for the quarter, an increase of 27% year-over-year. Adjusted operating income for this segment was $5.2 million in the quarter. This included a one-time annual true up of approximately $2 million that we don't expect to recognize in the future years. As we have said before, last year's revised agreement with one of our partners in this segment provides us higher margins at higher growth rates, which now makes this partnership sustainable moving forward. In total, adjusted operating income was $23.8 million in Q3 ahead of expectations. This was up 42% from Q2 and up 8% from the prior year period.

During the quarter, we deployed $16.1 million to acquire approximately 71,000 new subscription pets, excluding the approximate 3,900 European pets. This translated into a pet acquisition cost of $212 per pet in the quarter. This compares to $268 in the prior year period and $236 in Q2. We also invested $1.6 million in the quarter in development costs. As a percentage of revenue, development expense was approximately

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half a percentage point compared to 1% 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.

Stock-based compensation expense was $6.6 million during the quarter. Keep in mind that most of our stock-based compensation is performance based and vests over a four year period, approximately $4.5 million of the stock-based compensation expense recognized in the quarter related to grants for performance in 2019, 2020, and 2021. As a reminder, we did not have a performance grant in 2022. As a result, net loss was $4 million or a loss of $0.10 per basic and diluted share, compared to a loss of $12.9 million or $0.32 per basic and diluted share in the prior year period.

In terms of cash flow, operating cash flow was $11.4 million in the quarter compared to negative $2.3 million in the prior year period. Capital expenditures totaled $4.4 million in the quarter. As a result, free cash flow was a positive $7 million and over $15 million improvement from the second quarter.

Turning to the balance sheet, we ended the quarter with $265.9 million in cash and short-term investments. Outside of our insurance entities, we held $37.9 million in cash and short-term investments, with an additional $15 million available under our credit facility. At the end of the quarter, we maintained $227 million of capital surplus at our insurance subsidiaries, which was $60.8 million more than the estimated risk-based capital requirement of $166.2 million.

I will now turn to our outlook. For the full year of 2023, we're increasing our total revenue guidance to be in the range of $1.100 billion to $1.108 billion, representing 22% growth at the midpoint. We're also raising the midpoint of our subscription revenue guidance to be in the range of $711 million to $716 million, which would represent 20% year-over-year growth at the midpoint. We're also increasing and narrowing the range for total adjusted operating income. We now expect total adjusted operating income to be in the range of $80 million to $83 million. At the midpoint of the range, this is a $6.5 million increase from our prior outlook. As a percentage of revenue, this continues to imply expansion in adjusted operating margin in the fourth quarter as our pricing actions flow more meaningfully through our book of business.

For the fourth quarter of 2023, total revenue is expected to be in the range of $287 million to $295 million. Subscription revenue is expected to be in the range of $190 million to $195 million. Total adjusted operating income is expected to be in the range of $24 million to $27 million. As a reminder, our revenue projections are subject to conversion rate fluctuations, predominantly between the U.S. and Canadian currencies. For the fourth quarter and full year 2023 guidance, we used a 74% conversion rate in our projections, which was approximate rate at the end of September.

I'm now going to hand the call over to Fawwad. Before I do so, I want to say, it was an honor to serve as an interim CFO for Trupanion and to get to know many of you. I look forward to continuing our conversations in the future. Thank you.

Fawwad Qureshi

Thank you, Wei. Good afternoon, everyone.

I'll be brief and use this opportunity to introduce myself. I look forward to getting to know many of you in the coming months. It's only been a few weeks since I joined, and I'm thrilled to find that everything I expected to love about this Company is true. This Company was built to change lives, and that passion is evident in my team members and in our goals. Having worked with major consumer brands, I can confidently say that our consistent growth quarter after quarter and our remarkable 98% monthly member retention rate sets us apart.

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I'm also impressed by our team's ability to navigate the business levers, balancing growth and profitability, optimizing prices and prioritizing cash flow. What attracted me to this role was the vast untapped market and the growing demand for our product in the years ahead. There has never been a greater need for pet insurance and Trupanion's world class products. Most importantly, I've enjoyed getting to know the team and witnessing their unwavering dedication to the Company's mission. We're positively impacting the lives of pets and their owners and veterinarians, and I'm excited to contribute to our mission.

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

Darryl Rawlings

Thanks, Fawwad.

It's great to have you on board and to see you hit the ground running. To Wei, thank you for your continued partnership and leadership.

Before we open it up for questions, I want to highlight that we'll be moving our Investor Day, historically held in June following our annual shareholder meeting to September. In doing so, we hope to create some more breathing room in what is typically a very busy spring schedule and drive greater in-person participation amongst our investors. Two thousand and twenty-four's Investor Day will be held September 18, once again in Seattle. Our event is optimized for in-person attendance, and those of you who have joined us previously can attest to the quality of conversations this allows for. With this in mind, we hope to see many of you in September.

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

Operator

(Operator Instructions)

The first question comes from Maria Ripps of Canaccord. Please go ahead.

Maria Ripps

Great. Thanks for taking my questions, and for Fawwad, congrats on joining the Company. First, your adjusted OI was stronger than expected this quarter and you obviously raised your full year guidance. Is there anything incremental to highlight in terms of your progress on closing that adjusted OI gap? How does your progress this quarter impact your goal of achieving 15% margin by the end of next year? Could we see that happening sooner? And maybe just a quick clarification, I think you mentioned a one-time drop payment. Did that impact adjusted OI? Maybe you could clarify that.

Wei Li

Hey, Maria. This is Wei. Thanks for the question. Yes, this quarter adjusted operating income came ahead of our expectations. I would say, the main driver are to like we are having margin expansion as the pricing actions flowing through more meaningfully into our books of business. Then we're more disciplined in terms of cost and also our pet acquisition expense. We continue to expect our margin to expand in the next few quarters through next year as we had expected. Along with that, we continue to expect the adjusted operating income to increase.

In terms of this one-time AOI from the other business segment, I mentioned earlier, as a reminder, with our pet best business partner, we had this amended agreement 12 months ago, October 1, 2022. Because of

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that, we get a higher margin upon a higher growth. I think this worked well for us over the past 12 months. We got about $2 million incremental margin, because their growth has been higher than expected. Yes, this is—I wanted to say this is the one-time annual true up for this quarter. We do not necessarily expect this to repeat going forward.

I can maybe turn to Margi to chime in more here.

Margi Tooth

Yes. Thanks, Wei. Hi, Maria. Overall for the AOI performance, really pleased with the results. It was good execution from the team. In terms of how this trends overall, this is our second highest quarter ever in Trupanion's history in terms of adjusted operating income. We're pleased with it. We do remain on track for the 15% by the end of Q4 at this point, we're not going to expect it to come sooner. We're still assuming the same operating assumption that we have been for the last two quarters with a 15% cost of care flowing through the book, we haven't seen anything yet to suggest that this needs to change. We are priced to that level headed into next year, and we're looking forward to continuing to execute with the same level of discipline. In the interim, though, we will remain very focused and disciplined in terms of our approach to capital deployment to maintain that progress.

Maria Ripps

Got it. That's very helpful. Then secondly, could you maybe share an update on the status of your refiling in California following sort of the partial approval you received earlier this year? Are you able to comment on whether you have refiled for the remaining rate increase? What are your thoughts on how some of the newer data you were able to provide or planning to provide should lead to approval for the remaining rate?

Margi Tooth

Yes, so we're continuing our dialogue with California. We mentioned after we got our approval in Q3, we've continued to refile in a number of states. So far, year-to-date, we've had over 90 filings that have been approved. Working well across the board with all regulators, and we'll continue to be disciplined and focused on getting the right rate to our target value proposition across the board. We've had very productive conversations with California and we will expect to file another rate before the end of the year. We have not yet filed that, to answer your question directly. Between then and now, we'll continue to be very granular in our approach and make sure we're growing in the right areas across the board, not just in California, to ensure we can maximize the returns on the capital we're deploying there.

Maria Ripps

Got it. That's very helpful. Congrats on the strong quarter.

Margi Tooth

Thank you.

Operator

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

Shweta Khajuria

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Okay. Thanks for taking my questions. The first one is for Margi, if you could please provide more detail on your comments on pricing power that Trupanion has. With the pricing increase going through the books, what gives you confidence in sustainability of your pricing power? Then second question I have maybe for Darryl, thoughts on the—not the lack of but surprisingly low buybacks given where the stock is today by directors, not only by you, but just across the board. Thank you.

Margi Tooth

Thanks. Hi, Shweta. I'll touch on that pricing power. A number of different indications across the business that are leading us to make this statement. First of all, our veterinary really biggest indicator is we see a greater need for our product than ever before. Our veterinaries are up, our conversion rate is strong. Most critically for us, our retention is very much in line with our expectations at this point. I do actually think at this point, I'd love to introduce Fawwad to the call to really provide a bit of color and context from his perspective. I think it will be helpful for the audience to understand your observations coming into the business.

Fawwad Qureshi

Yes. Thanks, Margi. Very nice to meet you, Shweta. I've only been here a short time, but I think one thing that has been notable for me is the pricing power of Trupanion. When we look at the numbers this year, there were 209,000 customers that received greater than 20% pricing increases. In the world I come from, that would be a significant increase. You'd expect consumers to react. In this case, we retained over 90% of these customers. Consumers, of course, are the ultimate judge of your value. What that tells me is when consumers engage with the brand, they value it. They chose to stick with us, because they value what Trupanion offers. From those pricing increases, we saw a percent increase in revenue within this cohort and a nearly 300% increase in adjusted operating income. This trade off was certainly financially accretive to top line and more impactful to AOI.

Margi Tooth

Darryl?

Darryl Rawlings

Hi, Shweta, to your question surprisingly low buybacks. I personally had a 10b5-1 plan, and when you cancel that plan, I'm not able to buy shares for approximately six months. We'll see what the opportunity lays ahead.

Shweta Khajuria

Okay. Thank you.

Operator

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

Joshua Shanker

Yes. Thank you very much for taking my question. This quarter, average pet acquisition cost was $212 per pet, down from $268 a year ago, you added 71,000 pets gross before contemplating those from the European Commission based pets. Maybe you don't have to spend as much to get the pets or would you have a substantially higher pet count at quarter end, if right now you weren't trying to get the margins back

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to stable? But what have we learned about how much we have to spend per pet in order to bring the pets that you want into Trupanion? After you get through this period of difficulty in achieving the 71%, 72% MLR goal, do you think that your spend per pet will be lower than it's been in the past?

Margi Tooth

Yes. Hi, Josh. If we kick off just in terms of the 71%, I just want to stress the message that you heard earlier that the 20% reduction in pack and essentially keeping our pet count consistent year-over-year is an exceptionally challenging thing to do. The team made it look quite effortless in the quarter. I'm very proud of the ability to pull that lever back. For us, the reason we broke out the internal rates of return by different cohorts is really to help give you that visibility into understanding what we will be trying to spend per cohort. We're not going to deviate from our 30% to 40% internal rates of return and we'll continue to focus on that. That may mean that that pack spend, as our margin increases, our lifetime value increases, we're able to spend more money to acquire a pet.

At the moment, our margin necessitates that we spend less, because we're seeing a lower lifetime value that will pick up over time as our margin continues to expand, as will our pack spend. It will be different by segments when you think by cohort. When you think about that core Trupanion subscription business, that pack will grow and it's actually higher than we've got different parts of the North American market that we can acquire pets at very different levels, because of their lifetime value. Our expectation is that higher pet count will come as we start to see that margin expansion, as we lean into our internal rates of return and we use the levers that we've dialed back over the last few months and start to push them back on again.

But we will continue to be disciplined. I think that's the key thing here, ensuring that we are living within that guardrail at 30% to 40% and admonishing the business accordingly. Once we see that margin expansion and we're seeing that margin expansion now quite solidly, this has been a very deliberate execution and a large sequential improvement for us quarter-over-quarter. It gives a little bit more leeway to push into more areas that are now priced appropriately and excited to see the teams have the opportunity to do that again with every quarter that comes.

Joshua Shanker

Do you think that the pets being added today have a lifetime MLR of around 71%, or is that going to be elevated because they start from a higher position?

Margi Tooth

Pets enrolling today?

Joshua Shanker

Yes.

Margi Tooth

Pets enrolling today. The pets that we're enrolling for the most part are absolutely they're priced appropriately. We are being very specific with how we're enrolling pets. As the rates get approved, as we focus on where we're growing, you'll see that loss ratio be consistent with our target value proposition, which is at 71%.

Joshua Shanker

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Then, I guess, in pets enrolled the last few years. Look, we understand the inflation came, it changed the numbers. If I was a person who bought—average customer who bought the product in 2021, is my average pet going to have a 71% MLR? Do you think that those cohorts are slightly higher than that because of the inflationary spike?

Margi Tooth

It depends when you enrolled in 2021. If we think about every 12 months, we're adjusting people's rates. Historically that has been adjusting either up or down. Lately, it's been adjusting up. You will be—across one of the reasons we've broken out the different segments is to demonstrate there is a dramatic difference between individual pets, whether that's location, age or breed. Our target is to get our book by and large at 71%. Our goal is to be pricing people with a value proposition as opposed to it being taking rate where we can. Our cohorts are slightly different just depending on the renewal rate in the year. But overall, our target is getting closer and closer to 71%. If you see that value proposition come down from where it was at 77%, you've heard it's come down 110 basis points. That's moving it closer to that 71% overall. Does that answer your question?

Darryl Rawlings

Josh, with our pricing promise, some people don't understand this. What we're charging for new members is the exact same rate that we charge for our renewing existing members, but some of them may be 11 months behind or something else. We offer the same value proposition, but if rates are $65 for a golden doodle today, that's what the new person is getting. When that person is renewing, they'd get the exact same rate.

Joshua Shanker

Thank you for answering all my questions.

Operator

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

Jonathan Block

Thanks, guys. Good evening. Maybe just the first question. It looks like the credit facility draw was $25 million, specific to the quarter, only $15 million left. Maybe if you could just talk to the decision to draw the $25 million, if you were decently free cash flow positive in the quarter. I thought I heard Wei say cash in excess of capital requirements was roughly $60 million. Maybe if you could just talk through those dynamics, and again, I think $25 million specific to the quarter was one of the bigger amounts that you've drawn in the facility to date.

Wei Li

Hey, Jon. As a reminder, our credit facility we entered into back in March 2022, about 18 months ago. At the inception, we drew $60 million initial term loan with $75 million term loan. We call it delayed draw term loan and $15 million revolver available. That $75 million delayed draw term loan has an expiration date of 18 months. By the end of September this year, according to the term, you either use it or you either lose it. That's the reason like we ended up drawing at the end of the quarter, which is in line with our plan. I hope that answers your question.

Jonathan Block

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No, that's helpful. I appreciate that. I guess still if you're $60 million in excess, why even draw that $25 million if Darryl, you're saying you feel comfortable with the 2.5% of revenue free cash flow positive going forward, but maybe the answer there is safety net and you wanted to access it. Is that fair? Then I can ask my second question.

Darryl Rawlings

Yes. I mean it makes, when we're cash flow positive, our $11 million operating cash and $7 million free cash flow, it certainly makes us a lot easier. But we had a date coming up and we need to make a decision. Did we want that extra buffer or not? It seemed prudent at this time and gives us a lot more flexibility.

Jonathan Block

Okay. Very helpful. Second one is going to be a little bit longer, so just maybe to move to the gross add. They were flat year-over-year, Margi, I think you pointed out, but I just want to make sure I have some of the numbers correct. Year ago, 71,000-ish gross adds were essentially all like call it core Trupanion. This year a similar number, but I believe 57,000 core Trupanion. The core Tru, which is the higher end or the white glove that was down, whatever that is, 15%, 20%. Then the fact that you're bringing on other pets, PHI or Furkin likely helps suppress that impressive pack of 212. Maybe if you can just talk through that and confirm it.

Then Part B, no relation, but Part B of a question would be can you talk to the sources of cash, your free cash flow positive, but reserves have been $18 million source of cash to date. Payables was $3 million in the quarter. Other was one-time of $2 million in the quarter. How sustainable are some of those when we think about free cash flow going positive? Thanks guys.

Margi Tooth

Yes. Hi, Jon. You're right. The 71,000 approximately a year ago, that was largely not entirely, but largely the core Trupanion subscription business. Part of our distribution strategy and the reason we've developed these new products and distribution channels is to provide us with different opportunities for growth and growth levers as and when we can push them. The core Trupanion product we have been very deliberate about ensuring our growth is happening in areas where we know we're priced appropriately. The last thing we want to do is bring a member on board and then have to change their rate quite steeply as quickly and we know we're not bringing them on at the right rate. It doesn't make sense to us to do that in terms of our value proposition.

For us, we've been very specific and strategic with how we're taking that pack on and looking at where we should be investing. Also, this quarter specifically, we had that goal of by the end of Q4 to be free cash flow positive, we've achieved that a quarter earlier than we anticipated doing so, which is really down to us prioritizing that cash and acknowledging that with margin, where margin has been this year, that's important to us. To really be in a position to get control over that operating position, that financial stability, to really be able to give us that cushion and then push into gross add. All in all, it's part of the strategy to ensure that we can get pet growth from any of our different business units. Really happy to see that extra contribution and it just helps us to grow into future spaces, future markets.

In terms of Furkin and PHI, you mentioned suppressing the pack. Absolutely. When we think about that middle bucket, that middle tier that we talked about, and you hopefully saw that slide on the screen and we were showing how that middle bucket performs very differently to the core subscription business. Within that, you do have Furkin, PHI, Chewy and Aflac, and they all perform differently as individual groups. We mentioned that they are not at scale. That scale is not related to their pricing. It is to your point, related to

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how much money we're spending and that comes into pack. It also comes into fixed expenses. We're looking at working to bring those products to scale over the next several months to make sure that we can continue to push on that as much as possible too.

Still very happy about the deliberate execution. I think that large sequential improvement and seeing that 20% reduction impact just means that the team is pulling those levers the way we want them to. I'll hand over to Wei to talk about the sources of cash. Wei?

Wei Li

Yes. With a free cash flow positive $7 million this quarter, that's $15 million improvement over Q2. As we mentioned before, our margin continues to expand. We're getting back to our target value proposition next year, and we'll stay disciplined on our capital deployment. We're actually very confident about our cash position, about the free cash flow to continue to be positive going forward on an annual basis.

Operator

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

Wilma Burdis

Hey, good afternoon. Could you help—this is a pretty broad question, but just help me, walk me through the cash flow. It improved pretty dramatically. I know some of it was less pet acquisition spend, but maybe just help me think through what led to that improvement.

Darryl Rawlings

Yes. Wilma, I'll take that. There's two main components. We've had sequential margin expansion largely due to our pricing, variable and fixed expenses are generally in line. Then we were deliberate about spending 20% less total dollars on growth. We could achieve free cash flow of about—this quarter was about 2.5%. We want to be modestly free cash flow moving forward, so that we control our destiny and we feel really good about the growth opportunities. One thing that I think is underappreciated is in the coming year, we mentioned earlier we had 209,000 pets that saw greater than a 20% rate increase. After that, we had a 10% increase in revenue, and adjusted operating income was up 300%.

Over the next year, we have about another 300,000 pets that will have that same opportunity. What we're trying to do is to grow revenue year-over-year. Sometimes you grow it with just pets, sometimes you do it with just ARPU. We're going to be gaining the benefit of having those ARPU increases as well. Great opportunity for pet growth, ARPU growth, margin expansion, free cash flow positive, and feel good about the future.

Wilma Burdis

Is that a good run rate into 4Q then on the cash flow?

Margi Tooth

Sorry. What was that? We didn't quite catch that, Wilma.

Wilma Burdis

Sorry. So, is this a good run rate into 4Q on the cash flow side?

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Margi Tooth

I didn't catch that.

Darryl Rawlings

Let me make sure we understand the question. Is the good run rate for Q4 cash flow?

Wilma Burdis

Yes.

Darryl Rawlings

Yes. We're expecting Q4 cash flow to continue to be positive.

Wilma Burdis

Okay. Then could you talk a little bit about the average price of the policies today, both for new business and for the in-force and how that's changed? I can estimate it, but just maybe give us some color on that.

Margi Tooth

Yes. If we break out, if we think specifically about the core Trupanion business, we've talked about that $66 average revenue, you can see how that's sequentially up 4.3% for ARPU, which is 1.1% sequentially. Nice improvement on that. It's been something that we've been trying to push through the year. Now we've got that pricing taking hold. To Darryl's point, with that 209,000 cohorts that have now had that larger than 20% increase. We're starting to see that really manifest itself in the numbers.

In terms of our existing book of business, that's new business will come on at the right rate. Existing business to Darryl's earlier point is now being priced. It's priced in line, so you're not going to see a different rate. We're making sure that we're able to uphold that value proposition to all of our members consistently.

Wilma Burdis

Okay.

Operator

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

Katie Sakys

Hi there, thank you for the question. First, to continue the discussion of free cash flow. I'm curious what's giving you guys the confidence that it'll continue to be positive over the next immediate couple of quarters? As you think about turning on growth again, what failsafe do you have in place to ensure that that doesn't complicate the free cash flow story?

Darryl Rawlings

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Well, I think the execution that the team demonstrated is a prime example. It's completely within our control. We understand our margins are expanding. The total adjusted operating income is our available pool of cash that we can reinvest. If we take a couple of percentage points off that and reinvest the rest, and then your positive free cash flow. Completely in our control, within our destiny, and we feel good about it. As I mentioned before, we are also going to get the benefit of ARPU expansion to help revenue growth in the coming year.

Katie Sakys

Okay. Then shifting gears a little bit, was there any reserve development in this quarter's invoice ratio?

Wei Li

Hey Katie, this is Wei. Yes. As a reminder, and our insurance companies, we have this intercompany agreement with our operating company, and which makes…

Darryl Rawlings

I think the question was reserves. Did we have any reserves change during the quarter?

Wei Li

No. Actually we didn't have any insurance reserve change or IVR change during the quarter.

Katie Sakys

Okay. Got it. Thank you.

Operator

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

John Barnidge

Good afternoon, and thank you. I was curious, as we think about the core business and then think about the new partnerships and how you're dimensioning them going forward, how do we think of a persistency level in the state of TruTopia? I know persistency by channels can change, but on a blended basis, where would you think it settles in as the core portfolio reaches that state?

Margi Tooth

Hi, John, it's Margi. We are really very happy with the performance we saw in Q3. In terms of the persistency, we've got a lot of pets, 209,000 just to reiterate that number members that have received that higher increase. We see such staying power. I think Fawwad mentioned earlier, we had 90% of those people staying with us after seeing a 20% plus increase, which is testament to the value proposition and the power of the Trupanion product. Across the business, we're looking at all of those cohorts, as we always do, and obsess about the member experience to make sure that we can make it as good as it can be.

In terms of TruTopia, we're seeing as we look at our reduced pack spend, the vet channel continues to be the main driver of leads. The second biggest driver of leads to that is our referral friend, our existing members, adding pets, that has been consistent throughout this period and really helps us to push into that efficiency, which then helps us in terms of TruTopia. We're seeing good progress. I'm happy with how that's

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working through the overall book of business at this point in time. We'll continue to keep that in our sights and in our mind as we consider the growth of future state. Does that answer your question?

John Barnidge

It does. Thank you very much. I appreciate that. Then I totally understand that the European operation has a different underwriting risk profile and relationship on the P&L. But at some point, you probably want to take the underwriting, the Trupanion, how do you think about input cost trends differing in Europe versus the U.S., Japan versus the U.S. because I know that's the market you're planning to enter, I believe mid next year. Thank you for the answers.

Margi Tooth

Yes. It's interesting, when you look globally across the veterinary landscape, everyone is seeing very similar trends. Obviously there's a relativity depending on the economy that we're operating in at that time. But whether we're talking about Australia, Canada, the U.S., and any parts of Europe we're operating in, the veterinary industry is short staffed. They're all under pressure. Those pressures lead to the cost trends that we're seeing, because vets have little choice but to increase the prices they're charging to ensure that they can sustain their businesses.

Now, that does vary degrees, as I mentioned. We talk about the average ARPU for a European member at this point being $25 significantly different to that across North America. But the value proposition and the value that Trupanion brings is the same no matter where you are. We're not changing our approach to that $0.71 from $1. We're making sure that we can give people a product that will help them to take care of their pet the way they need to take care of their pet. As long as that remains our focus, we absolutely believe that we have a huge opportunity in front of us and happy to see that starting to take hold in Europe with those countries coming online. You're right. At some point, we will have that underwriting for Trupanion that's work in progress, but really happy to get our teeth into what we see there as tremendous opportunities.

John Barnidge

Thank you.

Operator

This is the end of the Q&A session. The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.

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