



Trupanion, Inc.

Second Quarter 2024 Earnings Conference Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Maria Ripps, *Canaccord Genuity*

Brandon Vazquez, *William Blair*

John Barnidge, *Piper Sandler*

Jon Block, *Stifel*

Katie Sakys, *Autonomous Research*

Wilma Burdis, *Raymond James*

PRESENTATION

Operator

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

All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing star key, followed by zero. After today's remarks, there will be an opportunity to ask questions. To ask a question, you may press star, then one on your touchtone phone keypad. To withdraw your question, please press star, then two. Please note, this event is being recorded.

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

Gil Melchior

Good afternoon, and welcome to Trupanion's second quarter 2024 financial results conference call. Participating on today's call are Margi Tooth, President and Chief Executive Officer, and Fawwad Qureshi, Chief Financial Officer.

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

Before we begin, please be advised that remarks today will contain forward-looking statements. All statements other than statements of historical facts are forward-looking statements. These include, but are not limited to, statements regarding our future operations, opportunities and financial performance, pricing and veterinary industry inflation, and our ability to remediate our material weaknesses. These statements involve a high degree of known and unknown risks and uncertainties that could cause actual results to differ materially from those discussed. A detailed discussion of these and other risks and uncertainties are included in today's earnings release, as well as the Company's most recent reports 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, cost of paying veterinary invoices, variable expenses, fixed expenses, adjusted operating income, acquisition costs, internal rate of return, Adjusted EBITDA, and free cash flow. When we use the term adjusted operating income or margin, it is intended to refer to our non-GAAP operating income or margin before new pet acquisition and development expenses.

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

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

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

Margi Tooth

Thank you Gil. Good afternoon everyone.

After over a decade with the Company, I am honored to join you all today for my first call as the CEO of Trupanion. I look forward to spending time with many of you at our upcoming Investor Day in September, where I'll be joined by leaders from across the business for an extensive Q&A session.

Now, moving on to our results. Quarter two was a strong quarter for the Company as shown in our key financial markets. Our subscription business remains the financial engine behind our business, and in the quarter, revenue from this segment increased by 20%. Breaking down the components of this growth, ARPU increased by 11% year-over-year, a record pace since we became publicly traded 10 years ago, and pet count increased by 8%. Within our core Trupanion brand, ARPU expanded even faster at 13% year-over-year.

Modulating between growth and pricing is a focus of the team as we continue to work to achieve our target value proposition of 71% in our subscription business. In our large and under-penetrated market, adding and helping more pets remains a guiding mandate. However, we will only do so when we're confident that we can deliver on the member experience for which Trupanion is known. In the quarter, we had approximately 24% pricing rolling through our book and veterinary inflation remained consistent with our expectations at 15%.

Against this backdrop, retention in the quarter was strong with the average pet staying with us for over 60 months. This also includes our lower coverage and thus lower retention products. We're pleased with these

results, a reflection of our efforts to communicate our value proposition and improve upon our member experience. Within our core Trupanion product, approximately half of our Trupanion members have received a pricing increase of 20% or more over the last 12 months. Retention of this cohort continued to perform well in the quarter and was up both sequentially and year-over-year. These results demonstrate our focus on the member experience and early benefits from the migration to our new technology and automation platforms.

This new claims administration system has been in development for some time and we're pleased to see some initial benefits leading to a higher proportion of our claims being paid directly to the veterinarian and with record reimbursement timelines for those being paid in a more traditional way. We expect to provide you with more details on these investments, the early performance metrics, and our ongoing member experience roadmap at our upcoming Investor Day in September.

We recently received meaningful rate approvals in two of our largest states that are beginning to take effect. While these new rates will take time to run through our book, they should enable us to increase acquisition spending and pet growth in these regions now that we've re-established pricing that allows for estimated returns between 30% to 40% on new pet acquisition.

Adjusted operating income represents the funds we have to invest in growth, and in the quarter, these funds grew 48% year-over-year. Adjusted operating income for our subscription segment grew even faster at 63% and represents an acceleration from the 55% growth we reported in the first quarter. As a percent of revenue, subscription-adjusted operating margin expanded 280 basis points to 11% in the quarter marked progress towards our goal of 15% adjusted operating margin. As Fawwad will communicate, we remain on track to hit this target in the fourth quarter.

Operating our business within our target margin profile and IRR guardrails ensures the sustainability of our business, positioning us to help pets, pet parents, and veterinarians in the decades to come. The health of the veterinary profession remains critical to our success. Two years ago, we highlighted the growing burnout of veterinarians and their teams due to the rising cost of care, staff shortages, and overwork. At the time, we noted the need for 30% to 50% pricing increases, an estimate that has since been validated by veterinary industry inflation. Our members put their trust in Trupanion 24/7 and the value proposition of our core product is designed with a unique aged (phon) enrollment pricing approach. This removes the need for guaranteed annual rate increases simply because a pet has had a birthday.

We've created a solution that's designed to last that can be relied on with the same dependability as our pets provide to us. Yet this past quarter, recent reports from across the pet insurance landscape demonstrate that not every insurer can or will be there in the same way. The rate of veterinary inflation has tested the most established of players, and now over 100,000 pets are without coverage due to mispricing. This outcome is very unfortunate, both for the pets without coverage and the industry overall. It underscores the importance of Trupanion's approach to lifetime coverage and our simple, sustainable cost-plus model.

Unlike competitors who attract customers with low prices but limited coverage, we prioritize delivering the best value by offering comprehensive coverage and higher claims payouts. This approach ensures pets receive the care they need, resulting in higher customer satisfaction and exceptional lifetime value. By adding a fixed margin to our comprehensive plans, we maintain a sustainable business model with long-term benefits for our members, their pets, and the veterinary community. With low single digit penetration across our addressable markets, we have a long way to go to make the difference we aspire to. As margins move sequentially closer to our goal of 15%, we're pleased to be turning our attention back to growth.

With that in mind, moving back to the second quarter, we acquired 64,300 pets at an estimated internal rate of return of 37%. This represents a 15% decrease in new pets year-over-year on a reduction in pet acquisition spend of 17%. While we're not yet maximizing our uses of adjusted operating income for growth,

our margin expansion afforded us the opportunity to deploy approximately 6% more impact versus Q1. Our newer initiatives, including our powered by suite of products with Chewy and Aflac; our medium and low ARPU products Furkin and PHI Direct; and our products in Continental Europe comprised approximately 17% of our gross new pet adds in the quarter. We deployed \$1.8 million against these opportunities, just 11% of our pet acquisition spend, a conservative amount of capital given these products are early in the lifecycle and subscale.

Our continued discipline on acquisition spending, coupled with our increase in margin, led to \$4 million of free cash flow in the quarter. In summary, we're pleased with the quarter. The team's hard work and solid execution is showing good results, which bodes well for our margin and free cash flow goals. With less than 4% of pets insured in the US, Puerto Rico and Canada, and an equally low number across most of Europe, our mandate remains to enroll more pets. We will continue to do so prudently, gradually scale up our acquisition spend and prioritizing accordingly across cohorts as margins expand.

Now before I hand over to Fawwad, I'd like to briefly touch on an important update to underwriting factors in the property and casualty risk-based capital calculation that were recently approved by the National Association of Insurance Commissioners, the NAIC. These updates significantly decreased the capital intensity of our balance sheet. Although pet insurance continues to be subject to the same risk-based capital requirement factors as special property, within this update, pet insurance was designated as its own line of business. After more than two decades of discussions to recognize pet insurance in its own right, this is a big step forward for Trupanion and the category at large.

With that, I'll hand over to Fawwad to provide a detailed overview of our Q2 results.

Fawwad Qureshi

Thanks, Margi and good afternoon everyone.

Let me begin by congratulating Margi on assuming the role of CEO of Trupanion. I'm thrilled to be working with Margi to lead the Company into our next phase of growth. Our mission to help pet parents and the opportunity to work with Margi are the reasons I joined the Company.

With that, I'll turn to our Q2 results, as well as provide our outlook for the third quarter and full year 2024. It was another strong quarter, with revenue and adjusted operating income coming in ahead of expectations. Total revenue for the quarter was \$314.8 million, up 16% year-over-year. Within our subscription business, revenue was \$208.6 million, up 20% year-over-year.

Total subscription pets increased 8% year-over-year to 1,020,000 pets as of June 30. This includes approximately 46,000 pets in Europe which are currently underwritten by third parties. Average monthly retention for the trailing 12 months was 98.34%, down versus the second quarter last year. On a trailing three month basis, retention was up from the first quarter of this year. Total monthly average revenue per pet for the quarter was \$71.72, up 11.4% over the prior year period.

The subscription business cost of paying veterinary invoices was \$154.6 million, resulting in a value proposition of 74.1% and reflects a 290 basis point improvement over the prior year period. The primary driver of this improvement was margin expansion from our ongoing pricing actions. The quarter also benefited from prior period development of \$2.1 million or approximately 100 basis points of revenue. Our target value proposition for our subscription business remains 71% and we expect to achieve this in the fourth quarter. As a percentage of subscription revenue, variable expenses were 9.5%, down from 9.7% a year ago. Fixed expenses as a percentage of revenue were 5.3%, up from 5.1% in the prior year period. Our remediation work on material weaknesses is ongoing and this increase in spending continues to be in line with our expectations.

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 \$23 million, an increase of 63% from last year. Subscription adjusted operating margin was 11% of subscription revenue. This is up from 8.2% in the prior year quarter and represents approximately 280 basis points of year-over-year margin expansion as pricing takes hold.

Now I'll turn to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and a lower margin profile than our subscription business. Our other business revenue was \$106.2 million for the quarter, an increase of 9% year-over-year. The decelerating growth within this segment is expected as one of our partners, Pets Best, continues to enroll pets with their new underwriter.

Adjusted operating income for this segment was \$1.8 million, a decrease of 32% from last year, driven by a lower gross margin. This is consistent with our revised agreement with Pets Best, which has lower capital requirements and a different margin profile. In total, adjusted operating income was \$24.8 million in Q2, up 48% from Q2 last year and ahead of our expectations. In Q2, our higher margin subscription business comprised approximately 93% of our adjusted operating income. This is up from 84% for the full year in 2023.

As Margi mentioned earlier, we acquired approximately 64,300 new subscription pets in the quarter and deployed \$15.8 million to do so. Excluding the approximate 3,600 new European pets that are underwritten by a third party, this translated into an average pet acquisition cost of \$231 per pet in the quarter, slightly down from \$236 in the prior year period. The estimated internal rates of return on this spend was 37% in the quarter, in line with our target of 30% to 40%. We also invested \$1.7 million in the quarter in development costs, which relate primarily to our expansion efforts in Europe.

Stock-based compensation expense was \$8.4 million during the quarter. As a result, net loss was \$5.9 million or a loss of \$0.14 per basic and diluted share, compared to a loss of \$13.7 million, or a loss of \$0.33 per basic and diluted share in the prior year period.

In terms of cash flow, operating cash flow was \$6.9 million in the quarter compared to a negative \$3.4 million in the prior year period. Capital expenditures totaled \$2.9 million, down from \$4.7 million in Q2 last year. As a result, free cash flow was \$4 million, a \$12.1 million improvement from the prior year's second quarter. As we mentioned in our last earnings call, our free cash flow is seasonal, with the majority typically generated in the second half of the year. We are particularly pleased with our execution this quarter, achieving the highest Q2 free cash flow since the Company went public.

On our third quarter 2023 earnings call, we introduced an annual free cash flow target at 2.5% of revenue. I am pleased to report that we are making great progress towards this goal and have now generated \$23.9 million of free cash flow over the last four quarters. This compares to a negative \$31.1 million in the previous four quarters and represents an improvement of \$55 million.

Turning to the balance sheet, we ended the quarter with \$277.2 million in cash and short-term investments. Outside of our insurance entities, we held \$33.2 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 \$263 million of capital surplus at our insurance subsidiaries, which was \$130.3 million more than the estimated risk-based capital requirement of \$132.7 million. Excess capital has increased by \$66.2 million year-to-date due to our growth and our other business slowing, as well as recently approved changes to underwriting risk factors used in the calculation of risk-based capital requirements by the NAIC. We expect to discuss these changes in more detail during our upcoming Investor Day.

I will now turn to our outlook. We are updating our full year revenue guidance, which is now expected to be in the range of \$1.263 billion to \$1.279 billion or 15% growth at the midpoint. This takes into account our over-performance in first half. We are narrowing the range for subscription revenue, which is now expected to be between \$850 million and \$858 million. The midpoint of the range is increasing slightly and represents 20% growth year-over-year. We are also narrowing the range of our adjusted operating income guidance, now expected to be between \$108 million and \$115 million. We are raising the midpoint of the range, which represents 33% year-over-year growth. We continue to expect that our subscription margin will increase as we move through the year and build back to a 15% adjusted operating margin in Q4 of this year.

For the third quarter of 2024, total revenues are expected to be in the range of \$319 million to \$324 million, representing 12% year-over-year growth at the midpoint. Subscription revenue is expected to be in the range of \$217 million to \$219 million or 19% year-over-year growth at the midpoint. Total adjusted operating income is expected to be in the range of \$27 million to \$29 million. As a reminder, our revenue projections are subject to conversion rate movements, predominantly between the U.S. and Canadian currencies. For the third quarter and full year of 2024, we used a 73% conversion rate in our projections, which was the approximate rate at the end of June.

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

Margi Tooth

Thank you Fawwad.

Before we take our first question, we'd like to invite you to join us for our upcoming Investor Day on September 18 at our headquarters in Seattle. This annual event is a great opportunity for Investors to hear directly from over 20 team members leading the execution of our 60 month plan in an open Q&A forum. We will provide updates across each of our P&Ls and dive into progress across key metrics, such as retention rates, pricing, pet growth, hospital activity and PAC. The team and I look forward to seeing many of you there. More details, including registration, can be found on our Investor Relations website.

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

Operator

We will now begin the question-and-answer session. To ask a question, you may press star, then one on your touchtone keypad. If you're using a speakerphone, please pick up your handset before pressing the keys. In the interest of time, please limit yourself to one question and one follow-up. At this time, we will pause momentarily to assemble our roster.

Our first question comes from Maria Ripps from Canaccord. Please go ahead.

Maria Ripps

Great. Thank you so much for taking my questions and Margi, congrats. Now with the rate approval in California, can you maybe share a little bit more color around your plans to expand your customer acquisition efforts in your core geographies? Are there any sort of new strategies or new techniques that you may be planning to deploy now? When should we see sort of these efforts impacting your overall sort of subscriber count?

Margi Tooth

Yes, thank you Maria. To start with, in terms of California, obviously very pleased to get those two big State approvals during the quarter. That really does expand our overall addressable market now to over 85%, which is exactly what we were hoping for. We've stressed repeatedly that for us to be able to grow and put our foot on the gas in any of the different markets and cohorts we work with is really to ensure that we have that margin strength. We're priced appropriately for sustainable growth. We now feel that way for most of the country, as I mentioned, and most of North America. We're looking forward to expanding gradually into California.

The reality of that spend—to the second part of your question really leans into ensuring that we have both a strong lead development funnel, which is really primarily from the vet channel, and then looking at the conversion side of the funnel, which is pulling people through in terms of education, making sure they understand why Trupanion and really reinforcing that sales point.

For us, what we're looking at is expanding on the good lead development that's been happening over the last few weeks, not just in California, but across the market, and then starting to pull more of those people through the funnel. I expect the growth to start to pick up, like we've said before, very much in line with expectations towards the back half of this year.

As we move into the summer months, as more people are getting their pets, they're out, they're thinking about pet health, we're starting to see that growth. I'd expect to see that growth really kind of predominantly show up in the back half of Q3, Q4, and then fully leading into next year as well. Excited to see that coming through and really be able to put a foot on the gas a lot more, as we said, once we see that margin start to come back.

Maria Ripps

Got it. That's very helpful. Then secondly, can you make the refresh us again on what's driving higher-than-expected other revenue, and if it's still sort of largely driven by Pets Best? Can you maybe broadly, without getting into a lot of specifics, just broadly talk about sort of the relative economics of pets that you are acquiring now versus sort of why—your previous agreement with Pets Best?

Fawwad Qureshi

Sure, I can take that question. The quarter was—from our other business or Pets Best was largely similar to Q1. What we talked about in Q1 was continued roll off of pets. Revenue growth was driven by ARPU. That repeated itself in Q2. The majority of the revenue increase is related to ARPU. That business continues to be in secular decline. Within our expectations, it's rolling off pretty much within our expected range. I would say, continue to see that trend going forward. This was the first quarter on a year-over-year basis where we had single digit revenue in that business. Again, it speaks to the secular downturn as pets are rolling off, and we expect that to continue.

Maria Ripps

Got it. That's very helpful. Thank you both.

Margi Tooth

Thank you.

Operator

The next question comes from Brandon Vazquez from William Blair. Please go ahead.

Brandon Vazquez

Hi, everyone. Thanks for taking the question. First one, I think if I heard you correctly, you said retention was up on a year-over-year basis and even sequentially. Kind of curious if you think that we have hit a trough here and we're kind of on the rebound back up and we won't go backwards. Kind of curious your thoughts around that, and really what's driving the improvement in retention despite the fact that you guys are still pushing through some decent price increases.

Margi Tooth

Yes. Thank you for the question, Brandon. We are very pleased with retention. I think it's been something that we've talked about now for the last 18 months as one would expect with that high rate flow coming through. Those rates are driven through cost of goods as we see higher inflation of veterinary level. As a product, that's something that we know our members are looking for that value.

In terms of retention, a lot of what the teams have been doing is leaning into our value proposition, leaning into the reason why people choose Trupanion to start with, helping to educate the vets through—which really does help when pets go back into the veterinarian and talk about their rate increases. For us, though, it's about ensuring that the largest bucket of members, so our largest member retaining group now is in the over 20% bucket. This has evolved over the last 18 months as more and more rate has flown through, and that's really where the focus has been across the business.

From a member communication perspective, from a contact center point of view, as we manage the claims that come through, every element of the business has been ensuring that value proposition is depicted in the right way. For us now, I think it's hard to say where are we in that journey, but I would tell you that the sample size we have now is well over 55% of our members have received that high level of rate approval—rate increase. At this point, we have some good data to suggest that we're through the bulk of that and we look forward to having more and more of those rates come through, with California, New York rolling on. Then assuming that inflation remains consistent with expectations in Q1 of 2025, those high-level rate approvals and rate needs should be call it, in history at this point. That's assuming 15, which means it gives us a lot of confidence to be able to ultimately return to those high levels of retention that we got used to 24 months ago.

Good about the progress. We're not giving up. We keep focusing on this and overall very pleased that we have retention that we believe still to be double out of the industry and it highlights the market that we're in and the vets and the opportunity we have in front of us.

Brandon Vazquez

Great. Okay. Maybe as a follow-up, switching gears a little bit, now that your IRR has kind of gotten back into the 30% to 40% range and you're talking about increasing PAC, maybe talk to us a little bit about which of the buckets do you start putting a little bit more PAC into? I know in the prepared remarks, you talked about the lower cost options, maybe some international. As that starts to increase, where do we see it go, the next incremental dollar? Then how long does that usually take to flow through and start to reaccelerate net pet adds? Thank you.

Margi Tooth

Yes. No, thank you. We will go region by region, cohort by cohort. What we look at is a very granular level map of pets by pet, breed, species, geography, which now includes, as you mentioned, those other products. For us, it's about being—deploying every single PAC dollar diligently. That will be a combination

of what does it take to acquire a lead and what does it take to convert that pet and pull them through the funnel? It's a different length of time in terms of attribution to those journeys depending on the channel. For us, the vet channel has been, will always be our mainstay in terms of where we go and seek to educate pet parents at the ground level. We'll continue to do that.

I suspect you're going to see a little bit more noise from a media perspective above the line, so pulling people through from a brand point of view. That not only helps us from a conversion perspective, but it also leans a little bit to retention as well as people see that reinforcement and credibility of the brand.

In terms of products, we have been very diligent in ensuring that we are acquiring pets and the right products at the right times. You note that from the fact that our newer products reduced quarter-over-quarter as we really lent into the growth in our core. But we'll continue to lean into any of those products we can as and when we see there is a 30% to 40% internal rate of return. We'll adhere to that discipline and look forward to actually starting to see that growth pick up, which I suspect you'll see, like I said at the back half of this year, especially into Q4 as that PAC has returned quarter-over-quarter at a higher level.

Operator

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

John Barnidge

Good afternoon. Thanks for the opportunity. Congrats, Margi. My question, Margi, on your comment about a market participant in the market that dropped out 100,000 pets. Member experience is important for products where the market penetration is low. What's your expectation for other market participants in the rate in the backdrop of rate need for some? Does it create an opportunity to acquire books to ensure customers have good pet experience in a product with that low market penetration? Thank you.

Margi Tooth

Yes. Thank you, John. Yes, obviously for us, this is not a good thing as you say. We never want anyone to have a bad experience in a category that's underpenetrated. We're really leaning into early adopters and helping people to have that best experience from the outset. We know from history that's hurt the category growth back in the '80s when poor experiences were had. I think the learning from here is first and foremost horrible situation for those pet parents and as a category, as an industry, what we need to do is be able to get behind the veterinarians and help them reinforce the fact that players such as Trupanion are creating a product that's sustainable.

It really leans into the fact that you have got to understand the costs that go into pricing for those pets. Our aged enrollment pricing is very unique in the industry. We're the only people that do that, and that allows us to have a very clear vision for the lifetime of that pet. It's not an easy thing to do. I think if you think about the natural hurdles that you have coming into this industry, we've seen a lot of people come in. They've grown very quickly and they've not got their pricing right. We've proven over the last two years that we are ahead of the industry in terms of being able to react, even though we berated ourselves 18 months ago for being slow, we were significantly faster than the competition.

For us, I think we're never going to chase a pet count over the lifetime value and making sure that member experience is what it should be. I think we'll lean into the vet channel. We'll continue to share the fact that we are here for the life of the pet, we're here for them. I think when it comes to acquiring those pets, it's a challenge. The best member experience is having a puppy or a kitten or a new pet to the household that doesn't have pre-existing conditions that we at Trupanion can cover everything for that pet in that instance.

Many of those pets that're now are without coverage will have pre-existing conditions and that doesn't set the member up for the best experience.

For us, we'll continue to focus on that early entry point, and obviously hope that this doesn't happen for others. I think it's just a message to everyone that that pricing has got to be critical, it's got to be on point. I think we've proven that we're starting to see that come out the other side of that, and hopefully others will too.

John Barnidge

Thank you for that. My follow-up question maybe a numbers one, on the two material weaknesses. What was the size of that cost in the quarter? Where did we see it in the financial results? Thank you.

Fawwad Qureshi

Yes. You see the cost in fixed expenses. Fixed expenses were elevated. I think one of the advantages that we have as a Company is we have a very clear model P&L. That model P&L calls for fixed expenses to be 5% of revenue. They ticked up higher as expected, primarily related to the material weakness. There's a couple of dimensions to it. One are the costs of the actual remediation work. We talked in the last call about bringing on some resources as well as some external expertise.

The other is just from a technology perspective, because one of the MWS had to do with controls within technology. There's more engineering effort on remediation. You're seeing higher operating expense versus lower CapEx because more maintenance and support around remediation versus development. You see it in fixed expense.

John Barnidge

Thank you.

Operator

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

Jon Block

Thanks guys. Good afternoon. Maybe just the first one, I believe that variable expenses and other was up roughly \$7 million Q-over-Q, sort of like an unusual step-up low base, so call it like \$17 million in 2023 or \$16.5 million in 2023 and change. Maybe you could just shed some light on that magnitude of this sequential step-up.

Then, when I shift gears and I just look at where the gross adds are coming from, one of the newer opportunities is sort of like in the other North American subscription, not the core. I believe that stepped down from \$10,000 and change in 1Q to \$7,600 in 2Q. I expected that channel to get better, not sort of materially worse Q-over-Q as you sort of refine the plans and streamlined it. Maybe if you could just add some color to both of those, and then I'll ask a shorter follow-up.

Fawwad Qureshi

Yes, I can take the first one on variable expense. As we've talked about in the past, the agreement with Pets Best is loss-sensitive. Our margin is relatively insulated from either higher loss ratio or higher variable

expense. Variable expense in this case had to do with higher commissions. As that loss ratio is coming down, there's a higher earn. It doesn't affect our operating margin that's relatively flat quarter-over-quarter.

In the Q1 call, I talked about that being the new run rate for that business based on the new agreement. That's largely consistent with our expectations being flat Q1 to Q2.

Margi Tooth

Hi, John. Just on the gross adds and the other products, so one of the things that we've been learning with those new products is really leaning into what makes a good cohort for us. They are newer. We're learning how to both get leads and convert those pets and also ultimately retain them. We're looking at that IRR constantly to understand what's the best lifetime value. What we realized during the quarter is some of those products are still subscale, so we don't want to be pushing too much in there as we get more rate for our core products. You're seeing suddenly the balance moving back to core, but also really looking at growing the right way.

As we test and refine from a new product, new channel distribution perspective, we realize that some of the pets we're enrolling are not going to have that stickiness that we typically would be used to. The teams have slowed down that growth very deliberately, looked at how do we really deploy that PAC in the best way to get the right mix of pets and we're making some really good progress there. The beauty of having these different distribution channels, these different products, is that we do now have a choice. We don't just have to grow in one country, one geography, one product, and we're leaning into that flexibility depending, but always thinking about that 30% to 40% internal rate of return ultimately.

Jon Block

Got it. Helpful color. Thanks for that. Then just the second question, sort of a follow-up to a question that was asked earlier, but from a different perspective. On that competitor that turned off the 100,000 or so of subscribers, what's been the reaction? Not so much from the pet owner experience, but from the veterinarian community. Your biggest channel is going through the vets. You want them to stand behind, endorse bring up pet insurance and feel comfortable.

One of the assets that you brought initially to the industry was a transparent plan that was simple and easy to explain. When they hear about something like this going on, do they have more trepidation when they're engaging with pet owners? Thank you.

Margi Tooth

Yes. Thank you. That is a great question. Honestly, for us, that's really where we felt the initial need to educate our territory partners. As you know, these are the people who are going in the doors of veterinary hospitals, speaking to vets. They did have this conversation. It continues to be a pain point for vets. As you can imagine, many of their clients are going through this experience month over month.

It frankly, is an opportunity for Trupanion. We're there. We can explain firsthand not only what that situation, what leads to that type of situation, but also to reinforce the fact that in our coverage, Trupanion cannot just cancel a pet because we feel like canceling a pet. We are adhering to our lifetime value, to our pricing promise, and from our perspective, it's critical that vets know that and trust it. What I would say is an indicator based on those conversations, as we're seeing in the last few weeks, our veterinary lead traffic is higher than it's ever been before.

We're not pushing too hard on that conversion funnel yet, but that's a very good sign. It shows that we're able to demonstrate how we're different, why we're different, and to that point you made that transparency

in terms of our policy wording and our coverage has been critical to both get the trust of the vets and also retain the trust of the vets as they see this type of thing happening in the industry.

Operator

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

Katie Sakys

Hi. Thank you. Good evening. I want to circle back really quickly on the discussion for retention. Margi, would you be willing to quantify the extent to which retention improved on a trailing three-month basis for us?

Margi Tooth

We haven't shared that level of detail, but I think from the perspective of our core business, we've seen it improve ahead of our other products, which for us is symptomatic of really focusing on that and doubling down that big cohort because it's now today, it's over 55% of our members. But the expansion is moving very nicely, and we're very happy with that performance. It's pretty much in line with expectation.

Katie Sakys

Okay. Shifting to ARPU really quickly. It's impressively held in at almost 10% for the second quarter in a row now. Can you guys give any color on where you expect that to trend over the back half of the year as the remaining 45% of the book experiences those rate increases? Then perhaps adjacent to that, is there any portion of the book, and if so, what percentage that would face those large rate increases in the beginning of 2025?

Fawwad Qureshi

Yes, I can give some context just on the second half. Our expectation is kind of similar to what we saw in first half that this was a year that was going to be driven by more so ARPU than pet count given that we've been pulling back on acquisition spend. We saw that in Q2 where it was balanced, but a little bit more lean towards ARPU as a contributor to top line growth from a subscription perspective. We expect that that pricing flows through similar to what we saw in prior years, where you have first half being relatively flat sequentially and then expansion of margin in second half.

A lot of that expansion in second half is going to be driven by the benefit of that ARPU in our highest categories. As Margi mentioned, we are going to be increasing investment in acquisition. We're gradually increasing that again now that margins are closer to our target range. That's more an investment that's going to benefit us in the first half of next year, we want to hit the ground running from an acquisition standpoint. I would say second half is still going to be largely driven by our boom.

Margi Tooth

Then just in terms of the members facing large increases in 2025, for us, by the time we get to the end of this year, our book of business will have received the biggest increase unless we see an increase in inflation above the 15% in Q1. Now that we've level set the delta that we had from prior periods, we feel good about the fact that we have sufficient pricing flowing through the book of business that will have affected the entire book. By the time we get to Q1, our pricing that we have today will hold at that level. We shouldn't see the need to go above a 20% increase again next year.

Obviously, that's dependent on inflation. If we do see inflation move up, then our rates will move up again. But we feel like we're at a pretty stable state and look forward to being able to really focus on moving more of our members back to that sub-20% retention group over the next 12 months.

Katie Sakys

All right. Thank you.

Margi Tooth

Thank you.

Operator

Again if you have a question please press star, then one. Our next question comes from Wilma Burdis from Raymond James. Please go ahead.

Wilma Burdis

Hey, good afternoon. We've seen some industry articles discussing lower-than-normal vet visits in 2Q '24. I'm just curious if you saw any of those types of trends in the quarter. Thanks.

Margi Tooth

Yes. Hi Wilma. Our data actually suggests otherwise. We've definitely been following those trends in the industry. Typically, what we find, and what we've always found with a Trupanion member is that they do go to the vet more frequently than an uninsured client and removes barrier to care. It removes barrier to entry. People, when they see an issue with their pet, will go to the veterinarian without waiting, without pausing.

We've been leaning in a lot to the industry and hearing what's been happening from our territory partners and from the markets in general. What we're hearing is there are a couple of things at play here. One, down to the fact that puppies and kittens are not being purchased in the same levels that they were two years ago. There's less new visits, there's less new clients coming to the hospital, which is driving part of that visit pattern down.

The other is, anecdotally, we're hearing people are waiting to see how their pet does before they take them to the veterinarian, which obviously is not ideal for a pet parent to have to do. But when they're thinking about their finances and they're concerned about what that's going to cost, they're waiting. From our point of view, again, speaking to the point I made earlier, we're actually seeing more and more veterinarians leaning into the fact that they realize the higher proportion of their clients that are coming in are Trupanion members. They're recognizing the value that we offer to them and helping to generate more lead volume as a result of that.

It's counterintuitive initially, but when you think about the type of person that we attract and the members we have, that's why our patterns are slightly different. We are seeing, I will just add a slight downturn in July in terms of visits. We'll wait and see what happens there. But so far, our assumptions are remaining at 15%.

Wilma Burdis

Okay. Thank you. Then you raised the EBITDA by \$2 million in the quarter. Could you just talk about where that piece is coming from or what business line is driven by? Was it in other subscription? Or, was there some other impact? If you could just help us bridge that. Thanks.

Fawwad Qureshi

Yes. Our profitability is primarily driven by subscription overwhelmingly. The margin on the other businesses is relatively small, so the contributors largely are AOI driven. The more AOI we're generating as a result of the ARPU flow through that we talked about as well as continuing to enroll pets. Feel good about it, again, largely within line with our expectations. When we think about the overall plan, first half versus second half, we feel good about exiting the first half with some momentum and that bodes well for us in terms of having some optimism on second half.

Wilma Burdis

Great. Thank you.

Margi Tooth

Thank you.

Operator

There are no more questions in the queue. This concludes our question-and-answer session. Thank you for attending today's presentation. You may now disconnect.