



trupanion®

2016 ANNUAL REPORT



# 2016

## To Our Shareholders,

Our 2016 financial results are in line with the expectations we shared in the 2014 shareholder letter and prior. More importantly, we remain on track to deliver against our longer-term financial objectives when we hit scale. We are delighted that we became free cash flow positive as planned in the 2<sup>nd</sup> quarter and grew revenue 28%, hitting our revenue targets, while concurrently expanding our adjusted operating margin and cost-effectively reinvesting these operating profits to acquire new pets. As this year's group of pets realize the benefits of Trupanion, we anticipate Trupanion's shareholders will receive outsized internal rates of return on the capital invested in 2016.

Our first annual shareholder letter is attached as a reminder of how we operate and think about our business. If you are new to Trupanion, or simply need a refresher, we recommend you read or re-read this original letter prior to diving into this year's results.

As positive as we are about our financial metrics, I do not believe they tell the full story. Execution is difficult to accomplish and sometimes even more difficult to measure. I believe that effective execution in any company requires a combination of a strong team with a shared focus on education and communication, a resilient culture, the right set of tools, and a dash of luck. In my opinion, when considering these important areas, our execution was mixed in 2016.

It is my intention to use this letter to not only share our financial performance, but also highlight some of the accomplishments and challenges we experienced in 2016 that might not show up in our financial metrics.

Certain financial results and metrics discussed in this document are on a non-GAAP basis. Refer to our investor relations website for details on our non-GAAP financial measures.

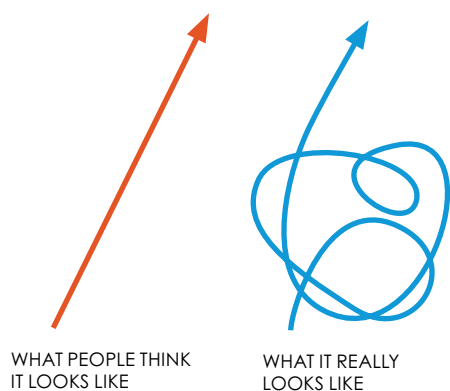
## AUDACIOUS GOAL-SETTING THROUGH OBJECTIVES

Every five years, we conduct long-term strategic planning where we set our audacious goals. Each of these goals is measurable, specific, and designed to break new territory and be audacious to the point of impractical. Why? Because ordinary, easily-attainable goals don't lead to extraordinary results — or extraordinary businesses.

We developed audacious goals for 2010 and 2015 and are currently working toward the 2020 goals. We run an annual exercise to determine what we need to accomplish in the following year to track to our five-year goals. On a quarterly basis, we revisit this annual goal and translate it into quarterly corporate objectives that give our teams clarity into our focus for the quarter, which tracks to our annual goal. Each team then creates their own quarterly objectives to support the corporate objectives. Finally, every team member has individual objectives that build toward their team's objectives.

We aspire for complete transparency, which we believe leads to greater fulfillment at the individual level and greater resiliency at the team level. My intention is for every team member to have visibility into the quarterly objectives of each department and of every other team member. One way we promote transparency is to track objectives live on TV screens throughout the building, so we can see our progress by the hour. We also distribute daily, weekly, monthly, and quarterly performance reports company-wide. We wholeheartedly believe that the more insight each team member has into our business and metrics, the more they will understand how their role affects the bigger picture, leading to higher individual fulfillment.

Success Graph



When things do not go as planned, transparency helps enable a healthy and productive response. For example, in 2016 we had a strong focus on expanding our adjusted operating profit and hitting our 5x LVP:PAC ratio while also being free cash flow positive. This is important to us as we try to drive shareholder wealth creation and set the company up to aggressively grow this category over the next two decades. As a result of this focus, we had key metrics in our corporate objectives around our revenue growth, adjusted operating margin, and our LVP:PAC ratio. In 2016, we allowed very little room for error in accomplishing our goals, and our quarterly objective achievement score



was lower in 2016 due to our “tough” grading bell curve. Without the context and insight we share throughout the year, team members may have reacted negatively. But because they were well-informed and understood the intended nature of the goals, they had a healthy reaction.

I share all of this with you so you can better understand how we approach our business. Without this level of transparency, we aren’t able to achieve alignment across the organization. Alignment is key because we are all working together to build a new category, and that means we must be able to test and learn. We shouldn’t always expect straight As if we want to be successful. We must embrace our failures as learnings and opportunities so we can continue to lead the category. I frequently tell the story of WD-40 (yes, the blue spray can with the red straw that we all keep in our garages). The short version of the story is that WD-39 did not work! It took 40 attempts to make an effective water displacement lubrication product. The result of this perseverance was a product so ideally suited to its purpose that it has yet to be replaced in our homes after 58 years. Aspirations that are difficult to achieve are game-changing; they are the foundation of the moats that we should all desire in a great company.

We have a “WD-40” culture where there are no bell curves to grade ourselves against. This gives us room for failure and learning. The fact that we have not had a single month in the last five years in which our revenue has been less than our previous month’s revenue also makes life easier. We work hard, embrace challenges, and love building moats.

## 2016 Financial Performance

Our **total revenue was \$188.2 million**. We spent \$133.3 million paying our members' veterinary invoices and an additional \$21.4 million in variable expenses supporting our members. Our fixed expenses were \$18.8 million, leaving us with **\$14.8 million in adjusted operating income**. We invested **\$14.7 million of this profit to add new pets**. This resulted in \$0.1 million in adjusted EBITDA, translating to \$3.1 million in free cash flow.

When you back out the \$2.1 million we received in sign up fees and the \$0.2 million related to our other business segment, our net pet acquisition cost was \$12.4 million in 2016. With this investment, we added 100,692 new cats and dogs, with an average monthly revenue per pet (ARPU) of \$48.81 to our book of business. Assuming that these pets act like our average pet in 2016 with constant 7.9% adjusted operating profit and an average duration of 71.4 months, we calculate the internal rate of return (IRR) of this cohort to be **31%**.

See **Table 1** for comparative metrics over time.

**Table 1.** Financial Performance 2012-2016

	Enrolled pets	Revenue	YoY revenue growth	Adjusted operating income	Invested capital to acquire new pets	IRR on a single average pet <sup>1</sup>	Cash and short-term investments minus debt	Earnings (Net Loss) <sup>2</sup>
2012	127,704	\$55.5M	50%	\$3.0M	\$6.7M	n/a	\$5.1M	(\$8.1M)
2013	182,497	\$83.8M	51%	\$4.3M	\$8.4M	n/a	\$7.9M	(\$8.2M)
2014	232,450	\$115.9M	38%	\$0.9M	\$11.1M	n/a	\$60.6M	(\$21.2M)
2015	291,818	\$147.0M	27%	\$3.6M	\$14.8M	n/a	\$43.2M	(\$17.2M)
2016	343,649	<b>\$188.2M</b>	28%	<b>\$14.8M</b>	<b>\$14.7M</b>	<b>31%</b>	\$48.8M	(\$6.9M)

Let's take a detailed look at how we calculate the IRR. First, we would anticipate revenue to be \$351 million over 71.4 months. We would expect to spend approximately \$246 million paying our members' veterinary invoices and \$78 million on both our variable and fixed expenses, leaving us approximately \$27.7 million or 7.9% of revenue ( $\$351M \times 7.9\% = \$27.7M$ ) as our projected adjusted operating income. A \$12.4 million investment for an estimated \$27.7 million return on that investment is 2.2x. We calculate the IRR on this investment to be approximately **31%**.<sup>1</sup>

<sup>1</sup> IRR under our methodology was not meaningful prior to 2016 due to the amount we spent on our fixed expenses, and using a static projection of our current % of fixed expenses into future periods. As we are able to scale our fixed expenses, this calculation has become meaningful. For our IRR calculation, we assume all pets will act as an average pet with a constant ARPU and adjusted operating margin for 71.4 months on a non-GAAP basis and also including a capital charge. For more detailed information to guide your own models, please refer to our investor relations website.

<sup>2</sup> Net loss attributable to common stockholders.

## FINANCIAL PERFORMANCE PER SHARE

Growth is an exciting story, certainly, but it has to be on a per share basis to generate true value for our shareholders.

See **Table 2** for per share metrics over time.

**Table 2.** Growth Per Share

Date	Total share count plus options & warrants granted	Revenue per share	YoY growth	Adjusted operating income per share	YoY growth	Cash & short term investments minus debt per share	YoY growth	Earnings (loss) per share <sup>3</sup>
2012	22,467,205	\$2.47	53%	\$0.13	-7%	\$0.23	-30%	\$(9.76)
2013	24,889,316	\$3.37	36%	\$0.17	31%	\$0.32	39%	\$(6.23)
2014	33,813,736	\$3.43	2%	\$0.03	-82%	\$1.79	459%	\$(1.64)
2015	34,138,237	\$4.31	26%	\$0.11	267%	\$1.27	-29%	\$(0.62)
*2016	34,879,610	\$5.40	25%	\$0.42	282%	\$1.40	10%	\$(0.24)

\*2016 includes the total share count plus options and warrants granted at 12/31/16 of 34,431,970 plus 447,640 options to be granted in May 2017 pertaining to 2016 performance (discussed on page 9).

Dilution is an impediment to value creation, so I would like to take a moment to discuss how our methodology is evolving.

We mentioned in the 2015 shareholder letter that:

*"We expect our adjusted operating income to organically fund our annual revenue growth in the range of 20% to 30%. It will not be enough to fund our growth in the range of 40% to 50% at our target 5x LVP:PAC ratio."*

The limiting factors on our growth rate are the time to become cash flow positive on the addition of a new pet and the fact that as we add revenue, we need to set aside cash for surplus capital. The first factor is self-imposed as a matter of financial discipline; the second factor is externally imposed by our regulators. We do not plan to raise additional capital unless, of course, we find that "silver bullet" for cost-effective accelerated organic growth. We have yet to find such a solution, but believe me, we keep looking. Two abstract options we have considered are deploying capital toward a long-term, cost-effective new pet channel and paying up front for assets that would sit on our balance sheet and help lower ongoing frictional costs. If we were to find an opportunity in one of these areas, depending on its size and our cash position at the time of its discovery, it is possible that it may involve an equity capital raise and therefore result in dilution.

<sup>3</sup> For comparison purposes, we are including earnings per share which ties to our financial statements filed with the SEC. This amount is calculated using weighted average basic shares outstanding since use of fully dilutive share count would be anti-dilutive to the calculation.

The other component of dilution is the value that Trupanion shares with team members and the board in the normal course of business. The extent of this dilution in any given year is capped by a formula based on our estimate of the year-over-year change in the company's intrinsic value. There is minimal dilution unless intrinsic value growth is at least 10%. Beyond 10%, more value is shared with the team in the form of an **overall company performance pool**. See **Table 3** for details.

Stock grants fall into four buckets. The first is new-hire and promotion grants. Our intention is for each team member (full-time or part-time) to receive a new-hire stock grant. Promotion grants are top-ups for existing team members upon promotion, to ensure they own the total number of shares we would have granted if they had been hired to the same position as a new team member.

The second bucket is individual performance compensation, which comprises rewards made to individuals whose contributions can be tied to intrinsic value creation. Depending on our cash position at the time of the award, this may be in either cash or stock.

The third bucket is board compensation, which serves to further align our board members with shareholders.

The final bucket is the overall company performance grant. This grant comprises the balance, if any, available under the dilution formula after the first three buckets have been awarded.

**Table 3.** Performance Grant Program\*

YoY increase to intrinsic value @ the enterprise level	<b>Overall company performance pool %</b>	Net increase in intrinsic value per share
1 - 10%	<b>0.0%</b>	1 - 10%
11%	<b>0.3%</b>	10.7%
12%	<b>0.3%</b>	11.7%
13%	<b>0.4%</b>	12.6%
14%	<b>0.4%</b>	13.6%
15%	<b>0.5%</b>	14.5%
16%	<b>0.6%</b>	15.4%
17%	<b>0.7%</b>	16.3%
18%	<b>0.8%</b>	17.2%
19%	<b>0.9%</b>	18.1%
20%	<b>1.0%</b>	19.0%
21%	<b>1.1%</b>	19.9%
22%	<b>1.3%</b>	20.7%
23%	<b>1.4%</b>	21.6%
24%	<b>1.6%</b>	22.4%
25%	<b>1.7%</b>	23.3%
26%	<b>1.9%</b>	24.1%
27%	<b>2.0%</b>	25.0%
28%	<b>2.2%</b>	25.8%
29%	<b>2.3%</b>	26.7%
30%	<b>2.5%</b>	27.5%

\*The above table is used as a guideline. The board may adjust at its discretion. The overall company performance pool is calculated from fully diluted weighted average shares outstanding. There likely will be some level of dilution when the increase in intrinsic value is below 10% due to new-hire and board grants.

In 2016, based on our internally calculated appreciation of the company's intrinsic value, the total size of the grant pool equaled 469,577 RSUs which we converted into **1,114,304 options** this year. Out of this option pool, **new-hire and promotion grants** equaled **209,800 options**, **individual performance grants** equaled **292,250 options**, and **board compensation grants** equaled **164,614 options**. Therefore, as of December 31, 2016, the size of the **overall company performance grant** was calculated at **447,640**, the difference between the **total grant pool** of **1,114,304** minus the 666,664 options granted during the year. In May 2017, the **447,640 options** will be granted with a four-year vesting period. In the future, grants may be awarded as options or restricted stock. See calculation in **Table 4**.

During 2016, 296,223 options were canceled or forfeited, therefore the dilution since my last shareholder letter, related to 2016 performance, was 1,114,304 minus 296,223 (818,081). The weighted average strike price for these options issued since the last shareholder letter was \$14.03.<sup>4</sup> If 100% exercised, the company would receive approximately \$15.6 million.<sup>4</sup>

I believe that sharing a small percentage of the net value creation with the team will continue to drive the correct alignment, and ultimately, the value creation between the company's team members and shareholders. All team members, excluding myself, have 3,642,944 options, or 10.4% of the total number of outstanding shares, stock options, and warrants (including the May 2017 grant for 2016 performance). Of these 3,642,944 options granted, 1,377,777 options remain unvested, and the aggregate strike price payable to Trupanion if they were all exercised is approximately \$25.7 million.

**Table 4.** Overall Company Performance Grant

<b>Total grant pool</b> size of options determined by appreciation of the intrinsic value of the company	<b>1,114,304</b>
<b>New-hire and promotion grants</b>	<b>– 209,800</b>
<b>Individual performance grants</b>	<b>– 292,250</b>
<b>Board compensation grants</b>	<b>– 164,614</b>
<b>Overall company performance grants</b>	<b>447,640</b>

<sup>4</sup> Includes all options issued in 2016 and 447,640 options to be granted in May 2017 (assumed at a \$15 strike price).



## VARIOUS CHALLENGES AND DISAPPOINTMENTS BEHIND THE NUMBERS

Our dogged focus on hitting our financial targets had various negative impacts in 2016. Put simply, in order to achieve our financial targets, we made operational compromises, both deliberate and unintentional. First, in my opinion, we grew too cautiously this year. Although we hit the top end of our revenue growth plans, we did not execute as many tests as I would have liked. Second, we put significant strain on our operations teams this year. They carried a lot of the load in driving our efficiencies, but our 2016 compensation model didn't have them sharing in those benefits. Third, as we focused on our financial metrics, our culture took a back seat. Team members did not feel like their concerns were being heard, and we struggled with communicating solutions in a way that made an impact. Once we became aware of these cultural missteps, we faced them head-on and made some significant changes, including the development of a new team tasked specifically with managing cultural initiatives.

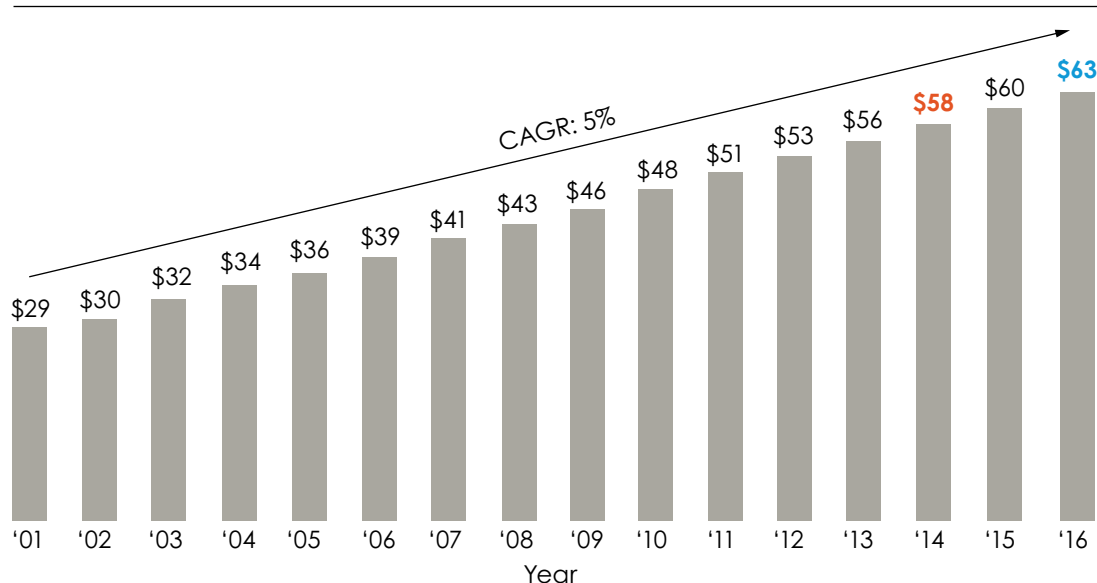
In Q2, we broke the proverbial camel's back when our growth caught up and then surpassed our human bandwidth to handle members who had failed payments. This is an area that did not scale with the business, and we burned out the team handling these cases by not expanding their headcount or providing them with better tools. Our solution was to upgrade our systems, and we have reason to believe that we now have a scalable process. We will find out over time if the new systems and tools will allow us to improve these historical metrics.

My biggest disappointment in 2016 related to the key metric we introduced in our 2015 letter — our version of Nirvana, where our churn is offset by our existing members adding pets or referring their friends. Put bluntly, we not only did not make any forward progress in this area, we actually took a small step backward. The gap increased from the monthly average of 0.64% in 2015 to 0.73% in 2016.

## BIG PICTURE: THE PROBLEM WE ARE SOLVING

The 180 million cats and dogs in North America are well-loved. Pet owners in the United States spent an estimated **\$63 billion** on their cats and dogs in 2016 (up from **\$58 billion** in 2014). If you include Canadian pets and the estimated spend on non-reported pet services, the number climbs to approximately \$80 billion. Currently, a single overnight stay at a doggy daycare easily runs at \$75, dog beds tend to be over \$100, and the average cost of a Halloween costume is around \$45. An average Trupanion policy, at approximately \$50 per month, seems a bargain in comparison! As seen in **Table 5**, pet owners are spending more on their pets each year.

**Table 5.** Total US Pet Industry Spend (in billions)



Source: APPA US Pet Industry Spending Figures & Future Outlook

As a reminder, at our average monthly cost of approximately \$50, every 1% of market penetration is equal to \$1 billion in annual revenue. In parts of western Europe, Australia, New Zealand, South Africa, and Japan — where pet owners equally love their pets — we estimate insurance penetration rates vary from 5% to 15%. This increases to 25% and 40% in the UK and Sweden.

We are often asked why the North American market is still so under-penetrated at less than 2%. In our opinion, the answer is exactly the problem we are trying to solve. Prior to Trupanion, there was not a high-quality, high-value option that veterinarians and their staff could "confidently" recommend. This is the precursor to making medical insurance "normal" for responsible, loving pet owners. In the UK, the experience when checking in your pet at the veterinarian is similar to the experience North Americans have at their dentist's office: the first thing they are asked at check-in is, "who is your insurance provider?"

Our challenge is also our opportunity. The North American market is considerably larger than the international markets listed above. Building trust with approximately 28,000 veterinary hospitals — 26,000 of which are independently owned and operated — takes time and a healthy dose of persistence.

But our data is persuasive. We know Trupanion members spend approximately \$3,000 more on veterinary services over their pet's life compared to those without Trupanion. This is because Trupanion members who bring their sick pets in sooner, choose treatment plans based on medical, not financial, decisions. This results in more trusting relationships between veterinarians and their clients and a major reduction in what may be termed as "burnout," "compassion fatigue," or "ethics exhaustion" as veterinary staff members are no longer forced to move forward with treatment they deem unacceptable because of a pet owner's financial situation.

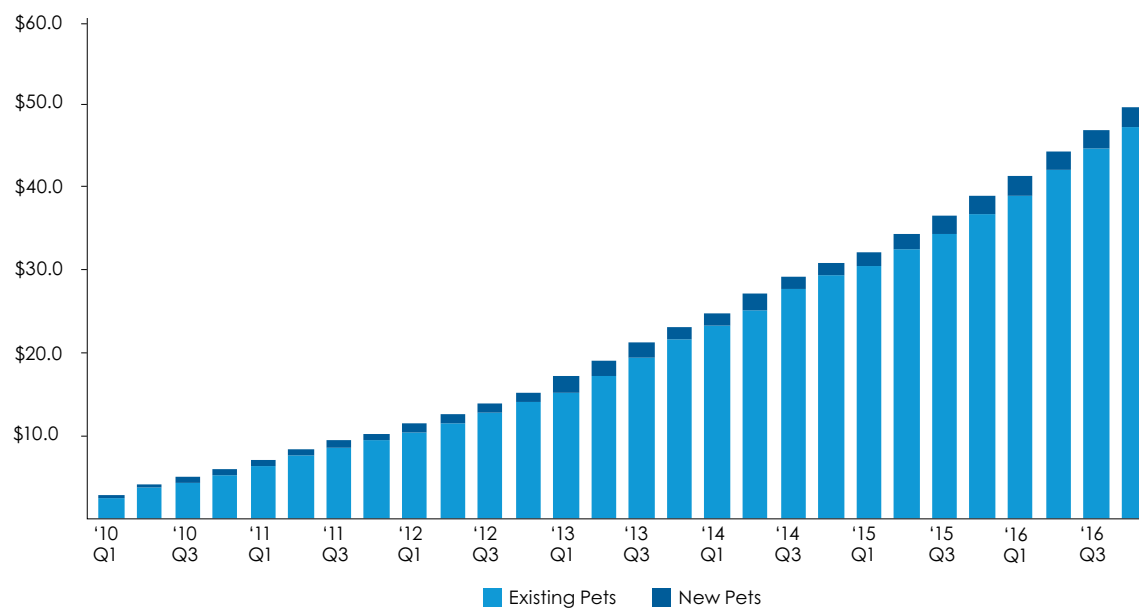
## TRUPANION EXPRESS

As I've mentioned before, from day one I've known the reimbursement model doesn't work. Reimbursement is slow and fraught with uncertainty — not to mention pet owners who can't afford treatment for their pet also can't afford to pay up front and get reimbursed later. Filling out a bunch of paperwork, taking photos of invoices, and submitting claims, then waiting beside your mailbox for several weeks with your fingers crossed that a reimbursement check will arrive is not the type of member experience that will drive referrals or grow this category. We want to pay veterinarians directly. We ended 2016 with Trupanion Express installed in over 1,400 hospitals. Additionally, we paid \$30 million in claims directly to hospitals, up 41% from 2015. While we are proud of this growth, we are working diligently toward the day when 95% of our members' invoices are paid directly and instantly to the veterinary hospital or referral center, and the Trupanion member is only responsible for their portion of the bill.

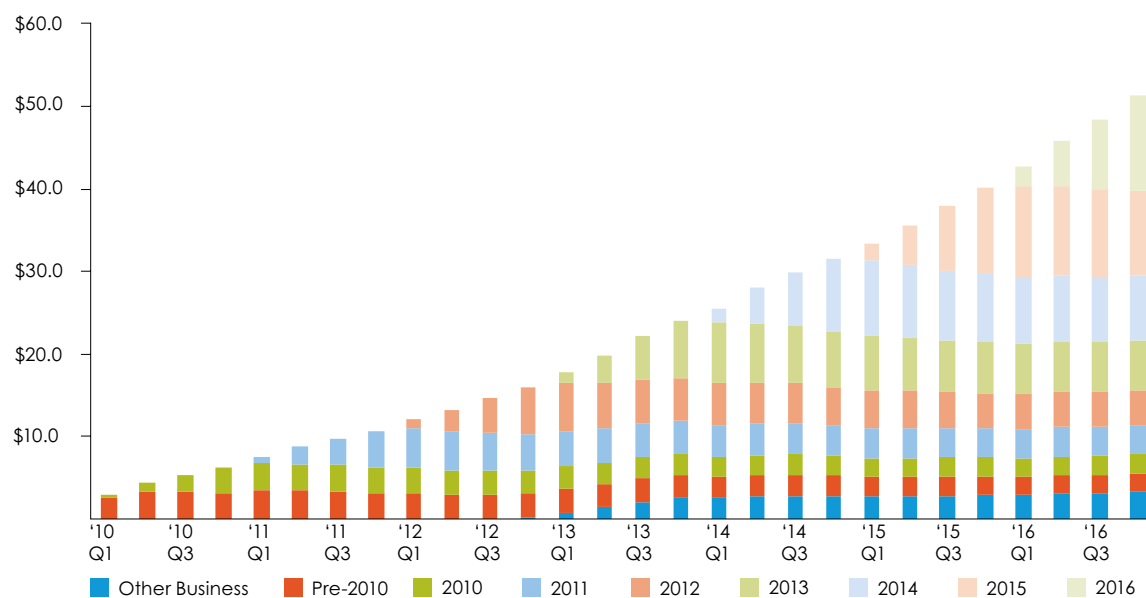
## GROWTH

2016 was a consistent year of growth. We ended the year on the upper end of our 20% to 30% revenue growth target. Total enrolled pets increased from 291,818 to 343,649. ARPU increased another 6%. Once again, we had strong visibility into anticipated revenue as 94% of our revenue goals were achieved each quarter from our existing book of business. See **Table 6 and 7**. I love direct-to-consumer, monthly recurring revenue businesses!

**Table 6.** Total Revenue by New vs. Existing Pets (in millions)



**Table 7.** Quarterly Premium by Policy Start Year Cohorts (in millions)





To me, we are growing effectively when we can deploy our adjusted operating income, which I expect to compound over time, in a manner that consistently achieves outsized internal rates of return compared to alternatives available to our shareholders. Our growth strategy has seven levers we can regulate to achieve different results:

1. Number of stores
2. Same-store sales
3. Direct-to-consumer marketing
4. Pet owner referrals
5. Other revenue
6. New products (Example: Goldfish insurance)
7. New businesses (Example: Another self-driving electric car)

## 1. Number of stores

The number of stores, which in our case are veterinary hospitals actively recommending high-quality medical insurance for a pet's entire life, has been our key growth driver since we enrolled our first pet (my dog Monty) in 2000. The true value of Trupanion is in the brand reputation that we have been slowly earning every time one of our Territory Partners walks through a hospital's front door. In the early days, we had a few hospitals recommending us in and around Vancouver, BC. After several years and admittedly many failures, we successfully expanded across Canada, and eventually into the US. We learned that over time (typically two to three years of repeated visits), a veterinary hospital becomes confident in Trupanion and will begin to initiate conversations with pet owners about the benefits of high-quality medical insurance for their pets.

There are four known drivers to building the number of stores recommending our product:

- Improving the value proposition of our product and its alignment with veterinarians. To be successful at building moats, you always need to have the best product. In our case, it needs to be the best-valued product for responsible, loving pet owners as well as veterinarians and their staff. This is the lens that we use to incrementally improve our product offering. An important measure of our value proposition is the percentage of our customers' monthly costs that we return to them by paying veterinary invoices — in 2016, this number was 72%. Our goal is to drive this percentage as high as possible, while also investing in exceptional, 24-hour service — all within the economic model of a 15% adjusted operating margin (before investing in adding more pets).

- Adding geography. In our case, a geography or “territory” includes roughly 3 million people, 1.8 million cats and dogs, and 250 veterinary hospitals. Approximately 150,000 new puppies and kittens are purchased in each territory per year — creating ongoing opportunities to provide each new generation of pets with high-quality medical insurance for the pet’s entire life — our optimal target.
- Adding Territory Partners. This is our unique approach to a local field team, modeled after the early Coca-Cola distributor model. Each Territory Partner’s goal is to build long-term relationships with the approximately 250 veterinary hospitals in their territory. In 2016, we increased the number of Territory Partners from 84 to 104. This additional headcount allows us to enter some new markets as well as increase the frequency of our visits in our more established markets. We believe that Trupanion remains the only company with a national footprint throughout the United States and Canada. Eighty-percent of hospitals are located within Territory Partner territories, with a target of visiting them every two months.
- Providing more tools to support veterinarians in recommending high-quality medical insurance for the pet’s entire life. Years ago, we only had a single brochure with a picture of my dog, Monty, on the cover. Today, we have a vast array of tools designed to help veterinarians and their staff feel confident recommending our product. These tools include daily, weekly, and monthly reporting packages; educational materials in print and digital formats; newsletters; merchandise; and Trupanion Express.

In 2016, the number of active hospitals recommending Trupanion peaked at just over 8,100 hospitals, compared to the 7,660 we ended with last year. This represents approximately 60% of hospitals where we have been calling on veterinarians for over ten years. Keeping this in mind, we believe with enough time and perseverance, we can visit 25,000 hospitals across North America and have the potential to achieve success in establishing positive relationships with at least 60% of them — a total of approximately 15,000 hospitals.

## 2. Same-store sales

Our second driver of growth is in same-store sales. So far, Trupanion has not figured out a way to accelerate same-store sales growth beyond what happens naturally over time. At least this was the case until we ran a small but encouraging pilot at the end of the year. I’m not in a position to share all the details of this yet, but in short, the good news is that we have a road map to where we want to go; the bad news is that it is still a dirt road and we have a long way to travel. For the next several years, we will build on this pilot in an attempt to add new stores while increasing same-store sales. We will keep you all informed as we continue to learn more about trying to do two things at the same time.

### 3. Direct-to-consumer marketing

Direct-to-consumer marketing is our third growth driver. We were a little too cautious in 2016 and did not conduct as many direct-to-consumer tests as we would have liked. We believe that in mature markets where the majority of veterinarians are actively recommending Trupanion, we will one day be able to cost-effectively use medias such as television and radio to market to leads that already have positive associations with our brand. We will need many iterations of testing to achieve success, and while we made little progress towards this goal in 2016, I expect more testing to take place in 2017.

### 4. Pet owner referrals

Our fourth driver will become an increasingly significant factor as we scale. It most certainly will need to be improved when we are attempting to grow from one million to two million total enrolled pets. I am referring to the organic growth of our existing members adding pets or telling their friends about Trupanion as compared to our churn. As I mentioned earlier, this was a disappointment in 2016. Our long-term aspiration is to have our churn offset by these referrals, and we did not make progress in this area. Although it is not totally clear how we will achieve this lofty goal, we know it is centered around improving our member experience and our overall value proposition. A Net Promoter Score (NPS) is one of the ways we should measure our success against this goal and something we have used in the past. For those not familiar with NPS, it is used to score a member's willingness to recommend our business to others, fitting hand-in-hand with customer loyalty and satisfaction with our product. By definition, members with a higher NPS are more likely to refer their friends to Trupanion.

### 5. Other revenue

"Other revenue" is developed through business-to-business partnerships where large numbers of pets come onto or off of our books as a group. Corporate employee benefits and veterinary employee benefits fall under this category, as well as our continued relationship with the US Veteran's Service Dog Program. Also of note in this category is our renewed focus on using our underwriter, American Pet Insurance Company (APIC), to issue policies for other brands of medical insurance for pets. In 2017, APIC will start issuing policies for Pet's Best, a well-established brand that entered the US market a year or two before Trupanion. Their new business will hit our financials in 2017 — an estimated 20,000 pets over the first year. As a partner, we will not report any specifics about their business.

We believe that over the next 10 to 20 years, Trupanion will be a major catalyst for growth in the category of medical insurance for pets in North America. If this is true, there will be other interesting product offerings and distribution models that will find their niche. Instead of sitting on the sidelines, our strategy is to participate through business-to-business partnerships. We are confident that we have the infrastructure, people, and data to help the companies behind these distribution models and niche products. We will do so without losing sight of our ultimate goal of building the category around the Trupanion brand — continuing to offer the highest value proposition in the industry with a strong alignment with the veterinary community.

We are open for business, so if there are any newcomers with proprietary or unique distribution methods, we are interested in speaking with you.

## 6 & 7. New products and altogether new businesses

The first five levers above are things we currently look at to drive growth. The final two levers — adding new product lines like goldfish insurance or altogether entering a new business category such as self-driving electric cars — are common strategies many companies look at to drive growth. However, we currently have no short-term intentions or resources pointed toward them. We have a very large, under-penetrated market that will take decades to develop. Plus, to be perfectly honest, we believe that we lead the category — but we are years away from being great at what we currently do.



## 2016 Learnings

Every year, we look back on the previous 12 months to identify what went well and what could have been improved. We then use this knowledge to make changes — both minor and significant — in the following year. This year, we learned some new things and reinforced some previous learnings from years' past.

### ONLINE REVIEWS AND POST-CALL SURVEYS

We are extremely focused on the member experience, so we consistently seek feedback and review what our members say online. On the positive side, we're happy to see that many members are happier than ever! We use a post-call survey to poll actual members after they talk to someone on our Contact Center team. We received over 15,000 reviews in 2016, and they scored us an average of 9.41 out of 10.00. Considering that by segment, these are not our happiest members because they usually call us with a question, we are proud of this score.

In the past, we received an NPS of 88% from our happiest members (those for whom we are able to pay their hospital directly within 5 minutes). No surprises there. Since that time, we have dramatically increased the number of such direct payments.

Unfortunately, we also see a small number of negative scores on online review sites. Although we have not been able to validate many of the negative reviews as authentic Trupanion members, 245 negative reviews (less than four out of five stars or equivalent) were posted in 2016. We added these reviews up from what we consider to be the five platforms most influential to a pet owner: Pet Insurance Review, Yelp, Consumer's Advocate, Trustpilot, and Facebook. Moreover, the number of reviews received on these platforms that are better than or equal to four out of five stars or eight out of ten stars amounted to 867 in 2016. Currently, Yelp has the highest ratio of negative to positive reviews, with 103 reviews that are four or more out of five stars balanced by only 39 reviews that are four out of five or greater in 2016.

While we're aware that even a handful of reviews can create a negative perception of our business online, we understand this is not reflective of our overall customer base, particularly in regard to the reviews left on Yelp. To put this into perspective, we paid approximately 490,000 veterinary invoices in 2016 and took an additional 429,000 customer service questions, so 245 unhappy members represents a small percentage of those who interacted with us this year. But their comments are still impactful. We continue to pay close attention to them and evaluate and refine our strategy in this area. As the category leader, we want to make sure that every member experience is exceptional and that our value proposition is obvious to an informed pet owner.

## ACTIVE HOSPITALS AND SAME-STORE SALES

As I mentioned previously, in 2016 we had approximately 8,100 veterinary hospitals actively recommending us. This was below the expectations that we had at the start of the year. However, this was not particularly concerning as we were agile enough to shift our focus mid-year to begin some encouraging same-store sales initiatives. Historically, there is an inherent trade-off when we try to simultaneously attempt to increase same-store sales while adding more active hospitals. This year was no different. These new initiatives are centered around providing partnering hospitals with more data and information previously unavailable to us and doing so with an increased frequency compared to our historical touchpoints. If successful, we believe these new strategies aimed to improve same-store sales may also help us add the number of active hospitals if we can learn how to operationalize them. We expect it will take us several years for this old dog to learn these new tricks.

## EDUCATING OUR MEMBERS AND TEAM

Last year I said that we needed to do a better job educating pet owners on the specific benefits of Trupanion. I am pleased that our content improved immensely in this area in 2016. Now if a pet owner does their research, they can easily compare Trupanion to other insurance providers on our website and also delve deeper into our product offering. Our next challenge will be increasing the traffic to this content.

While we are on the topic of education, it begins at the home office. One of the biggest steps we've taken over the last couple of years has been with Tru-University. Tru-University was first developed to increase training and education for our Territory Partners, but now is open to all team members. As we expand this offering, courses will range from a one-week introduction to the company, to classes on our culture, to in-depth training on specific topics.

When a company is trying to create a new category, one cannot hire experts. By its very nature, there are no experts in this field; they need to be developed and trained. Historically, I have said that it takes three years for someone to learn our business, but with Tru-University, we're aiming to create Trupanion experts in half that time.

In total, our company invested \$2.9 million on training and education in 2016. Expect this number to continue to increase in the coming years.

## **MACHINE LEARNING AND AUTOMATION**

Learning has now expanded beyond the humans that we touch (pet owners, veterinarians, team members, and Territory Partners) and now includes computers, thanks to Trupanion Express. We continue to use proprietary data to help us achieve efficiencies and make smarter decisions in almost every aspect of our business. Our pipeline of upcoming projects for our data science team blows my little human mind. We look forward to sharing more with you as we continue to make progress in this area.

## **PERFORMANCE COMPENSATION MODELS**

Ten years ago, our compensation model followed that of a scrappy, disruptive growth company. At that time, it made sense, but over the last five years we began to morph to more of a “market-based” approach which, with enough time, would yield market-based results. In 2016, we made small strides connecting compensation to our value creation. Compensation models are one of the best tools we have to create focus, alignment, and ownership. I am confident we are starting to make progress in this area, and when combined with our culture and educational initiatives, this will help differentiate our company in a very positive way over the next decade.

## Key Metrics for Today and the Future

One of the reasons that we have always included our 2014 shareholder letter in our annual report and encourage re-reading it is because we understand that our business is largely unknown and therefore can be complicated. The way we manage our business, including how we measure success, is important to understand, so these reminders are essential.

### A REMINDER WHY IRR IS SO IMPORTANT TO OUR BUSINESS

In our 2014 shareholder letter, we went into a good amount of detail explaining our business model and how we plan to reinvest the profits we collect from our existing members into building the business. Again, I encourage you to re-read the 2014 letter to refresh your memory, but here is an excerpt:

*"...we are most concerned with the metric of internal rate of return (IRR) for incrementally adding an average pet. We calculate the IRR by understanding our cost to acquire an average new pet and the free cash flows that we anticipate will be generated over the average pet's life. At operational scale of 650,000 to 750,000 pets, we should be able to achieve a consistent 70% claims margin, 10% variable expenses, 5%-6% for fixed expenses, and a discretionary margin of 14%-15%. In the next few years and before hitting scale if we can achieve a 7%-8% discretionary margin, our IRR should be in the neighborhood of 40%-50%."*

See **Table 8** for an example provided in the 2014 shareholder letter for illustrative purposes.

**Table 8:** 2014 5x LVP:PAC Business Model – Illustrative Example

<b>Months</b>	68	<b>LVP</b>	\$570	<b>DM</b>	8.1%				
<b>Churn</b>	1.47%	<b>LVP:PAC</b>	5x	<b>ARPU</b>	\$50.11				
<b>Year</b>	0	1	2	3	4	5	6		
<b>Months</b>	6	12	12	12	12	12	2	68	
<b>DM</b>	\$24.35	\$48.71	\$48.71	\$48.71	\$48.71	\$48.71	\$8.12		
<b>PAC</b>	-\$114								IRR
<b>FCP</b>	-\$89.65	\$48.71	\$48.71	\$48.71	\$48.71	\$48.71	\$8.12		47%
<b>LVP</b> = Lifetime Value of a Pet		<b>DM</b> = Discretionary Margin				<b>ARPU</b> = Average Revenue Per Pet (Unit)			
<b>PAC</b> = Pet Acquisition Cost		(now called Adjusted Operating Margin or AOM)				<b>FCP</b> = Free Cash Flow Per Pet			



As we continue to gain scale in our adjusted operating margin, we will use our target IRR to back into our desired PAC spend for a pet. In 2016, we had a **31% IRR** with a **5.1x LVP:PAC** ratio as seen in **Table 9**. This also reflects the incorporation of a capital charge which we had not previously included in the 2014 example in Table 8.

**Table 9: 2016 5.1x LVP:PAC Business Model – Illustrative Example**

<b>Months</b>	71.4	<b>LVP</b>	\$631	<b>AOM*</b>	7.9%			
<b>Churn</b>	1.4%	<b>LVP:PAC</b>	<b>5.1x</b>	<b>ARPU</b>	\$48.81			
<b>Year</b>	0	1	2	3	4	5	6	
<b>Months</b>	6	12	12	12	12	12	5.4	71.4
<b>AOM*</b>	\$23	\$46	\$46	\$46	\$46	\$46	\$21	\$274
<b>Capital Charge</b>	\$(2)	\$(5)	\$(5)	\$(5)	\$(5)	\$(5)	\$(2)	\$(29)
<b>PAC</b>	\$(123)							<b>IRR</b>
<b>FCP</b>	\$(102)	\$41	\$41	\$41	\$41	\$41	\$19	<b>31%</b>

\*Adjusted operating margin, previously referred to as discretionary margin.

**Table 10** demonstrates the leverage we can expect to receive on our IRR as we benefit from our adjusted operating margin expanding. If we are able to achieve a **10% adjusted operating margin**, even a lower **LVP:PAC ratio of 4.5x** would produce a higher **IRR (40%)**, compared to the 31% we achieved in 2016.

**Table 10: 4.5x LVP:PAC Business Model – Illustrative Example**

<b>Months</b>	71.4	<b>LVP</b>	\$631	<b>AOM</b>	<b>10.0%</b>			
<b>Churn</b>	1.4%	<b>LVP:PAC</b>	<b>4.5x</b>	<b>ARPU</b>	\$48.81			
<b>Year</b>	0	1	2	3	4	5	6	
<b>Months</b>	6	12	12	12	12	12	5.4	71.4
<b>AOM</b>	\$29	\$59	\$59	\$59	\$59	\$59	\$26	\$349
<b>Capital Charge</b>	\$(2)	\$(5)	\$(5)	\$(5)	\$(5)	\$(5)	\$(2)	\$(29)
<b>PAC</b>	\$(140)							<b>IRR</b>
<b>FCP</b>	\$(113)	\$54	\$54	\$54	\$54	\$54	\$24	<b>40%</b>

Fully at scale, if we have a **15% adjusted operating margin**, we would only require an **LVP:PAC ratio of 3.2x** to achieve a **45% IRR** as shown in **Table 11**.

**Table 11:** 3.2x LVP:PAC Business Model – Illustrative Example

<b>Months</b>	71.4	<b>LVP</b>	\$631	<b>AOM</b>	<b>15.0%</b>			
<b>Churn</b>	1.4%	<b>LVP:PAC</b>	<b>3.2x</b>	<b>ARPU</b>	\$48.81			
<b>Year</b>	0	1	2	3	4	5	6	
<b>Months</b>	6	12	12	12	12	12	5.4	71.4
<b>AOM</b>	\$44	\$88	\$88	\$88	\$88	\$88	\$40	\$523
<b>Capital Charge</b>	\$(2)	\$(5)	\$(5)	\$(5)	\$(5)	\$(5)	\$(2)	\$(29)
<b>PAC</b>	(\$200)							<b>IRR</b>
<b>FCP</b>	(\$159)	\$83	\$83	\$83	\$83	\$83	\$37	<b>45%</b>

Between now and when we achieve scale, we will be targeting our IRR around 40%. Longer term, we do not anticipate targeting an IRR above 45% as our market opportunity is just too large for us to not play more aggressively. By keeping IRR below 45% and accepting lower LVP:PAC ratios, we keep the door open to additional acquisition channels.

## LVP:PAC BY SUBCATEGORY

As I mentioned in the 2014 shareholder letter:

*"We have over 1.2 million price categories where we monitor our LVP:PAC and therefore our IRR by category. They will not have the same results. As we try to accelerate some channels and categories, some will scale well for a long time, others will have diminishing returns. It is our responsibility to understand when to put our foot on the accelerator, when to coast, and when to slam on the brakes."*

In 2016, our LVP increased 7% to \$631, giving us an allowable spend of only \$126 per pet if we want to be at a 5x LVP:PAC ratio. I feel that our LVP should be considerably higher at this point in our development. Therefore, I also would have expected our target PAC spend to have been much higher today — approaching \$150 using the same metric.

As this is a more complicated discussion, I would like to dig into this issue in greater detail with a couple of illustrative examples.

## VALUE PROPOSITION WITHIN SUBCATEGORIES

What we are trying to do is make sure every pet subcategory has the same value proposition. We do this by understanding the cost of paying veterinary invoices and adding 30% to cover our variable (10%) and fixed (5%) expenses while leaving a 15% adjusted operating margin (these margins reflect our plans at operational scale — we are not yet this efficient). When we break it out in this way, we end up with different lifetime values in each subcategory because they will all have a different average monthly cost and a different average retention period.

In the illustrative example, **Table 12**, pets in **subcategory 1** have an **LVP of \$544** which could be a \$10 contribution margin and stay with us for 54.4 months on average. Pets in **subcategory 2** have an **LVP of \$729**, which for illustrative purposes could be an equal contribution margin of \$10, but stay with us for an average of 72.9 months. As you can see, the retention period of a subcategory of pets greatly impacts the lifetime value of those pets.

**Table 12:** What We are Trying to Do – Illustrative Example

	# new pets	LVP/pet	LVP total	PAC/pet	PAC total	LVP:PAC ratio
<b>Subcategory 1</b>	200	<b>\$544</b>	\$108,800	<b>\$109</b>	\$21,760	<b>5.0x</b>
<b>Subcategory 2</b>	200	<b>\$729</b>	\$145,800	<b>\$146</b>	\$29,160	<b>5.0x</b>
Subcategory 3	200	\$1,100	\$220,000	\$220	\$44,000	<b>5.0x</b>
Subcategory 4	200	\$483	\$96,600	\$97	\$19,320	<b>5.0x</b>
Subcategory 5	200	\$100	\$20,000	\$20	\$4,000	<b>5.0x</b>
<b>Total/blend</b>	1,000	<b>\$591</b>	\$591,200	<b>\$118</b>	\$118,240	<b>5.0x</b>

Beyond having the same value proposition for each subcategory, we also try to get the same IRR on the money we invest to acquire pets in each subcategory. We attempt to do this by adjusting our available PAC spend for each LVP subcategory to target the same **5x LVP:PAC ratio**. This means that if we are successful, we would spend **\$109** to acquire a pet in subcategory 1 and **\$146** for a pet in subcategory 2.

What we report to our shareholders is our **blended total** for all of our subcategories.

We will be really good when we can modulate our mix of business and **accelerate** our growth in **high LVP** subcategories, while slowing growth in our lower LVP subcategories.

It becomes challenging in situations where subcategories have a much higher or a lower LVP compared to our blended average. **Table 13** shows that when we have a **\$100 LVP** in **subcategory 5** (say with an ARPU of \$25 per month, a \$5 contribution margin, and an expected retention period of only 20 months, like an older cat with a \$1,000 deductible), we can only afford to pay **\$20** to acquire this pet if we want the same IRR on our invested capital. By contrast, we can afford to pay **\$220** to acquire a pet in **subcategory 3**.

**Table 13:** If We Become Really Good – Illustrative Example

	# new pets	LVP/pet	LVP total	PAC/pet	PAC total	LVP:PAC ratio
Subcategory 1	200	\$544	\$108,800	\$109	\$21,760	5.0x
Subcategory 2	300	\$729	\$218,700	\$146	\$43,740	5.0x
<b>Subcategory 3</b>	<b>400</b>	\$1,100	\$440,000	<b>\$220</b>	\$88,000	5.0x
Subcategory 4	175	\$483	\$84,525	\$97	\$16,905	5.0x
<b>Subcategory 5</b>	25	<b>\$100</b>	\$2,500	<b>\$20</b>	\$500	5.0x
Total/blend	<b>1,100</b>	\$777	\$854,525	\$155	\$170,905	5.0x

In the 2015 shareholder letter, I said I wanted to improve our LVP:PAC ratio in each of our pricing subcategories. At the time, we had been close to hitting our 5x LVP:PAC target, achieving **4.5x**, but had misses in our subcategories due to two things: being mispriced and not being as accurate in managing our acquisition spend in relation to the lifetime value of those pets.

In 2015, our PAC spend was very similar from one subcategory to the next (**averaging \$132**, see **Table 14**) and therefore our **LVP:PAC ratio was fine on a blended basis**, but was a disaster in **subcategory 5** and amazing in **subcategory 3**.

**Table 14:** What We Did in 2015 – Illustrative example

	# new pets	LVP/Pet	LVP total	<b>PAC/pet</b>	PAC total	LVP:PAC ratio
Subcategory 1	200	\$544	\$108,800	<b>\$132</b>	\$26,400	4.1x
Subcategory 2	200	\$729	\$145,800	<b>\$132</b>	\$26,400	5.5x
<b>Subcategory 3</b>	200	\$1,100	\$220,000	<b>\$132</b>	\$26,400	<b>8.3x</b>
Subcategory 4	200	\$483	\$96,600	<b>\$132</b>	\$26,400	3.7x
<b>Subcategory 5</b>	200	\$100	\$20,000	<b>\$132</b>	\$26,400	<b>0.8x</b>
Total/blend	1,000	\$591	\$591,200	<b>\$132</b>	\$132,000	<b>4.5x</b>



I vowed that in 2016 we would spend more energy improving our accuracy in this area. What we attempted to do in 2016 was to stop enrolling pets in **subcategory 5** as we did not have the tools to effectively lower our acquisition spend to the allowable \$20 for these pets. As shown in **Table 15**, if we could have effectively accomplished this strategy in 2016, the **LVP for the 2016 mix of added pets would have increased to \$714** from \$591 and we would have had additional PAC spend of \$11 per pet, increasing it to a **\$143 blended average**, to either drive immediate cost-effective growth or to test future growth levers while maintaining a strong IRR.

**Table 15: What We Attempted in 2016 – Illustrative Example**

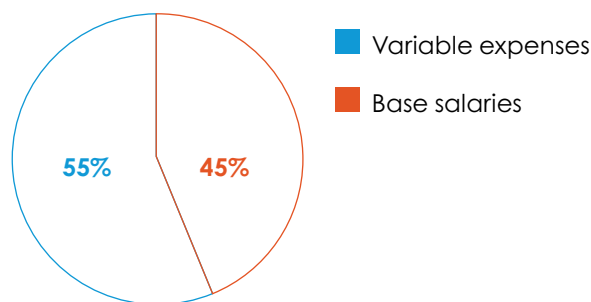
	# new pets	LVP/pet	LVP total	PAC/pet	PAC total	LVP:PAC ratio
Subcategory 1	250	\$544	\$136,000	\$143	\$35,700	3.8x
Subcategory 2	250	\$729	\$182,250	\$143	\$35,700	5.1x
Subcategory 3	250	\$1,100	\$275,000	\$143	\$35,700	7.7x
Subcategory 4	250	\$483	\$120,750	\$143	\$35,700	3.4x
<b>Subcategory 5</b>	<b>0</b>	<b>\$100</b>	<b>\$-0</b>	<b>\$20</b>	<b>\$-0</b>	<b>5.0x</b>
<b>Total/blend</b>	<b>1,000</b>	<b>\$714</b>	<b>\$714,000</b>	<b>\$143</b>	<b>\$142,800</b>	<b>5.0x</b>

It turned out to be much harder than expected to accomplish this, and it is taking longer to figure out than I would like. Let me try to explain why:

In 2016, we made progress by improving some of our known pricing misses, but we could not impact them all due to the speed of rolling pricing changes through our book of business and the data required to justify those increases to the regulatory bodies. Although I am confident that we exponentially lead the category in our data and pricing, we obviously have more work to do to get our pricing as accurate as we would like. This should continue to become more achievable as we get more and more data.

Our PAC spend is 100% of our sales and marketing department costs excluding stock-based compensation, other business, and offset by sign up fees, divided by the number of pets enrolled during a specific period of time. Our PAC spend is currently split between **base salaries** and **variable expenses**. See **Table 16**.

**Table 16: PAC Split – Illustrative Example**

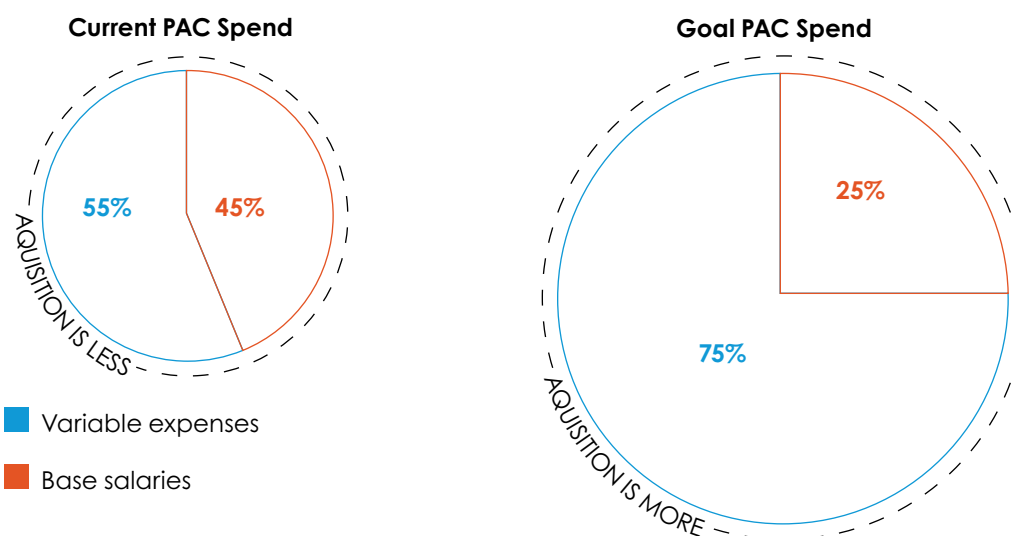


It would be operationally advantageous to decrease the fixed proportion of our PAC spend. For example, having our base salaries at **45% of our PAC spend** means that we need to enroll a large number of pets every month just to pay for headcount if we want to hit our 5x ratio. It also makes it difficult to accelerate leads by increasing our spend in different areas incrementally; this is particularly challenging with direct-to-consumer marketing. It is our aspirational goal to have base salaries become **25% of our PAC spend**, leaving us with more flexibility to pay for cost-effective leads and higher conversion rates. See **Table 17**. One can imagine that it takes longer than 12 months to change this dynamic, as it involves changing the way we compensate our team members for their contributions, but as I mentioned earlier, we are confident we are making progress in this area.

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**Table 17: PAC – Illustrative Example**

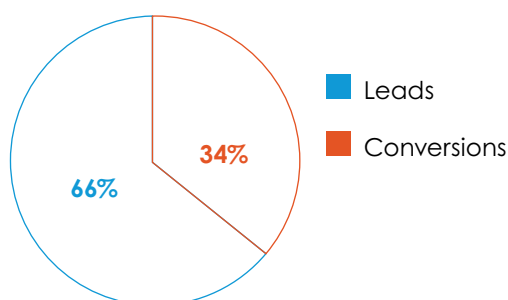
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Our PAC is also split between **leads** and **conversions**. See **Table 18**. With **34% of our PAC** spent on conversions, we need to learn how to modulate our conversion cost by subcategory of pets.

For example, targeting leads based on LVP is problematic for breeds. It is difficult to have a radio ad specifically target Golden Retrievers vs. Shih Tzus, for example. By contrast, it is easier to target LVP by geography. For example, we understand our allowable PAC budget per pet in New York City vs. Boise, Idaho.

**Table 18: PAC Leads & Conversions Split**  
– Illustrative Example



What we **actually accomplished in 2016** showed some progress in our ability to pay the appropriate amount of PAC for the corresponding LVP subcategory, but given the above constraints, our progress has been slower than what I desire. As you can see in **Table 19**, we were able to reduce our acquisition of some of the **lower LVP pets**, but not by as much as we hoped. We lowered **subcategory 5** from 20% of pets down to **17%**. We also made modest increases in our higher LVP subcategories. **Subcategory 2** increased from 20% to **22.5%** and **subcategory 3** increased from 20% to **24%**.

**Table 19: 2016 Accomplishments** – Illustrative Example

	# new pets	LVP/pet	LVP total	PAC/pet	PAC total	LVP:PAC ratio
Subcategory 1	165	\$544	\$89,760	\$110	\$18,150	4.9x
<b>Subcategory 2</b>	<b>225</b>	\$729	\$164,025	\$135	\$30,375	5.4x
<b>Subcategory 3</b>	<b>240</b>	\$1,100	\$264,000	\$165	\$39,652	6.7x
Subcategory 4	200	\$483	\$96,600	\$80	\$16,000	6.0x
<b>Subcategory 5</b>	<b>170</b>	\$100	\$17,000	\$110	\$18,700	0.9x
Total/blend	1,000	<b>\$631</b>	\$631,385	<b>\$123</b>	\$122,877	<b>5.1x</b>

Needless to say, we have plenty of opportunities to improve. Being really good at marrying our data with our execution and compensation models will help us build an even deeper moat.

## Conclusion

We have said previously that the business is simple, but execution is tough... We like tough.

We like WD-40's inspirational story. We look forward to 2025 when we expect to be really great at what we do. In the meantime, it is important that we are exponentially better than others and that we make incremental improvements every year.

In the 2014 shareholder letter, I stated our goals "may be aggressive, but I am committed to updating you on our progress." So here is my crystal ball update on hitting our scale: I still believe that 650,000 to 750,000 pets is the correct pet count window for the company to achieve a 15% adjusted operating margin before acquiring new pets. I originally stated a time frame of around 2020 to hit this milestone. Our reduction in testing last year has resulted in my crystal ball being a little opaque when it comes to specific pet counts several years out. This lack of clarity is because we anticipate that our adjusted operating profits will compound annually, providing us with incremental dollars available for us to invest in growth, but it remains unclear how much of these incremental dollars we will be able to deploy cost-effectively. For example, in 2016 we earned \$14.8 million in adjusted operating profits and reinvested \$14.7 million in what we believe was a cost-effective manner. The question is, with an additional \$5 million, then \$10 million, then \$15 million a year to invest in growth, will we be able to deploy the majority of it, while hitting our IRR hurdle rates? If we remain disciplined, we should either have higher growth with lower earnings or lower growth with higher earnings.

Moving forward, I expect my shareholder letters will have less detail, now that I have explained most of what I understand about our business. While future shareholder letters may be shorter, our goal is to increase the in-person attendance to our annual shareholder meetings in Seattle. We would like these meetings to one day have attendance representing 80%+ of our outstanding shares. We would like to have the meeting become an avenue for a two-way, lengthy conversation where our long-term, well-educated shareholders not only learn additional specifics about the company, but also build an understanding of our people and culture.

To help with attendance and planning, our next three annual shareholder meetings will be held in our Seattle office on the following dates:

- Wednesday, June 7, 2017, 10AM
- Thursday, June 7, 2018, 10AM
- Thursday, June 6, 2019, 10AM

If you are new to our story, dig in, do your research, and come meet our team in Seattle.  
If you are an existing shareholder, thank you for your continued support.



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**DARRYL RAWLINGS**  
**FOUNDER & CHIEF EXECUTIVE OFFICER**



trupanion®

2015 ANNUAL REPORT



# 2015

## TO OUR SHAREHOLDERS

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I am pleased to report that 2015 went as planned. It was a good year and one that I am proud of. More importantly, we are well on our way to meeting the commitments outlined in my first shareholder letter from last year. (I wrote this year's letter with the expectation that you have previously read my introductory public shareholder letter, which described how we operate and think about our business. If you have not previously had an opportunity to review it or if you would like a refresher, you will find it attached).

2015 ended with more Territory Partners out in the field, calling on the largest number of active hospitals in our history. We have more pets enrolled, and they are loyal — staying with us longer than ever. The number of Trupanion Express™ hospitals grew from 89 at our initial public offering in July 2014 to over 500 at the end of 2015. Most importantly, we helped more pet owners and their beloved pets receive the best veterinary care.

From my perspective, Trupanion continues to lead the creation of this new category of “medical insurance for cats and dogs” in North America. We are not “pet insurance,” we are different. To be blunt, we agree with pet owners and veterinarians that the traditional “pet insurance” is broken.

Trupanion stands apart as Medical Insurance for Cat and Dogs. As a reminder, we have no caps or limits, cover all congenital and hereditary conditions, and never penalize pet owners making a claim or for their pets having a birthday. While our policies are lifelong, they can be canceled any month only by the pet owner (unless fraud is involved). Our rates within a sub category go up or down to maintain our target of spending 70 cents of every dollar collected to pay veterinary invoices. These sub category prices go up and down constantly for new pets and are trued up for existing pets on the anniversary of their enrollment. Examples of subcategories include: cat, dog, age at enrollment, local cost of veterinary care, and deductible amount if a member chooses to have one.

We remain on target to achieve operational scale per the timeline described in our 2014 shareholder letter. As a reminder, we define scale as 650,000 to 750,000 pets, 5% fixed expenses,<sup>1</sup> and a 15% adjusted operating margin.<sup>2</sup> At scale, we anticipate this operating income will drive continued growth, funding new pet acquisitions and providing for our future capital requirements.

I remain committed to updating you on our progress toward our goals every year. Now, let's move on to our 2015 results.

## 2015 Financial Performance

This is how we think about our financial performance in 2015.<sup>3</sup> Our total revenue was \$147.0 million. We spent \$103.1 million paying our members' veterinary invoices and an additional \$18.4 million in variable expenses<sup>4</sup> supporting our members, leaving us with gross profit of \$25.5 million.<sup>5</sup> Our fixed expenses were an additional \$21.9 million, leaving us with \$3.6 million in adjusted operating income. We chose to invest \$14.8 million to add new pets during the year. Subtracting this acquisition cost investment from our \$3.6 million adjusted operating income yielded an adjusted EBITDA loss of \$11 million.<sup>6</sup>

Table 1 shows the progress of our key growth factors and cash balance minus debt.

**TABLE 1. KEY GROWTH FACTORS**

Year	Total Enrolled Pets	Total Revenue	YoY Revenue Growth	Adjusted Operating Income	Adjusted Operating Income Margin	Invested Capital for Acquiring New Pets (Acquisition Cost)	Cash and Short Term Investments, Minus Debt
2012	125,387	\$55.5M	50%	\$3.0M	5.4%	\$6.7M	\$5.1M
2013	182,497	\$83.8M	51%	\$4.3M	5.1%	\$8.4M	\$7.9M
2014	232,450	\$115.9M	38%	\$0.9M	0.8%	\$11.1M	\$60.6M
2015	291,818	\$147.0M	27%	\$3.6M	2.4%	\$14.8M	\$43.2M

As we continue to grow this category, we are most focused on increasing scale in our adjusted operating income while maintaining a high LVP:PAC ratio, which we target at 5:1. At this stage in our development, we believe these metrics are our best proxy to track changes in shareholder value creation. Over time, I expect we will transition from the LVP:PAC ratio to more of an IRR analysis as our fixed expenses and adjusted operating income begin to benefit from scale.<sup>7</sup>

## Adjusted Operating Income

In the second half of 2015, we made significant progress toward our long-term adjusted operating margin target of 15%. Previously, we labeled our adjusted operating margin as our “discretionary margin,” which was our non-GAAP term that describes the operating income from our existing members before any costs to acquire new pets. In 2014, this margin was less than 1%, due in large part to our significant investments in Trupanion Express™. As we moved beyond the development phase of Trupanion Express™ in the second half of 2015, we began to make

progress toward achieving scale in our adjusted operating margin. For the full year of 2015 it grew to 2.4%, but in Q3 and Q4 specifically, it trended up to 2.2% and 5.6% respectively.

We expect to achieve our stated goal of a 15% adjusted operating margin once we reach operational scale at 650,000 to 750,000 total enrolled pets. At operational scale, we expect our “COGS” and variable expenses to comprise 70% and 10% of total revenue respectively (their historic averages) and our fixed expenses to comprise 5% of total revenue, significantly

below today's level. Reducing our fixed expenses is our biggest opportunity to expand our adjusted operating margin from current levels.

In 2015, we spent \$22 million, or 15% of revenues, on our fixed expenses. This is a far cry from our target of 5%. Our fixed expenses break down into three buckets:



\$13 million spend in G&A;



\$5 million spend in our core technology; and



\$4 million (\$7M total, \$3M capitalized) investment to complete the development of Trupanion Express™.

The recurring portion of these expenses (excluding the development of Trupanion Express™) was \$18 million.

Moving forward, our strategy is to grow fixed expenses modestly — approximating 5% annually. We believe this will be an appropriate level of investment to maintain our category leadership, which is our primary priority. The math works this way: after 5 years of annual 5% increases, the fixed expenses would grow from \$18 million to \$23 million. During the same time, our top line revenue is expected to grow at a much faster rate. If after 5 years our revenue reaches \$460 million and our fixed expenses are \$23 million, then we would meet our target. While it's clear what we need to do to achieve a 15% operating margin goal, it will require scale, commitment, and discipline to execute.

We expect our adjusted operating income to organically fund our annual revenue growth in the range of 20% to 30%. It will not be enough to fund our growth in the range of 40% to 50% at our target 5:1 LVP:PAC ratio. This higher growth rate would require us to raise more capital, which would be dilutive and therefore, we believe, counterproductive to value creation. Hence, we intend to deliberately grow at 20% to 30% per year. The limiting factors for larger growth are the time to become cash flow positive on the addition of a new pet and the fact that as we add revenue, we need to set aside cash for surplus capital.

## Value Creation

Monitoring our dilution levels is another key area of focus for me. Our IPO in July of 2014 was intended to generate enough cash to fund us to the point of being cash flow positive, and we remain on course to deliver on this goal in the second or third quarter of 2016. My crystal ball tells me that it's going to be tight in the second quarter, but the third quarter should be doable. Regardless of which quarter in 2016 we become cash flow positive, we should not need to further dilute the value of our shareholders' positions with another equity raise unless the world changes dramatically from what we're seeing now or a compelling new opportunity presents itself. Each member of our team, full-time and part-time, receives stock options in Trupanion. Team participation in our equity program is another key priority of ours, aligning us all in our objective to maximize future value creation with limited dilution. If the stock options issued under this program are exercised, the company receives the cash from the strike price. If options are not exercised, the dilution is less.

Table 2 highlights our historic financial performance on a per-share basis. As you can see, our revenue per share has grown year over year, while our adjusted operating income has jumped around, due primarily to our expenditures on Trupanion Express™.

**TABLE 2. HISTORIC FINANCIAL PERFORMANCE**

Year	Total Share Count (including options and outstanding shares with warrants and granted options)	Revenue Per Share	YoY Growth	Adjusted Operating Income Per Share	YoY Growth
2012	22,467,205	\$2.47	53%	\$0.13	-7%
2013	25,611,542	\$3.27	32%	\$0.17	31%
2014	34,406,121	\$3.37	3%	\$0.03	-82%
2015	34,610,521	\$4.25	26%	\$0.10	233%

## 2015 Operational Performance

We have now completed the development phase of Trupanion Express™, our software technology designed to eliminate the traditional “reimbursement model” by enabling us to pay more veterinary invoices directly to treating veterinarians. Why is this important? For pet owners, their 90% coverage through Trupanion is paid directly to the veterinarian at the time of invoice, dramatically reducing out-of-pocket costs. For veterinarians, Trupanion enables them to move forward with “Plan A” care for any sick or injured pet while growing their top and bottom lines. More Trupanion Express™ hospitals lead to happier veterinarians and happier pet owners.

In total, we spent over \$17 million developing this technology, spending \$7 million on it in 2015 alone. These costs, net of amounts capitalized, are reflected in the technology portion of our fixed expenses.

We have now moved into the deployment phase of Trupanion Express™. Going forward, we anticipate continued maintenance and

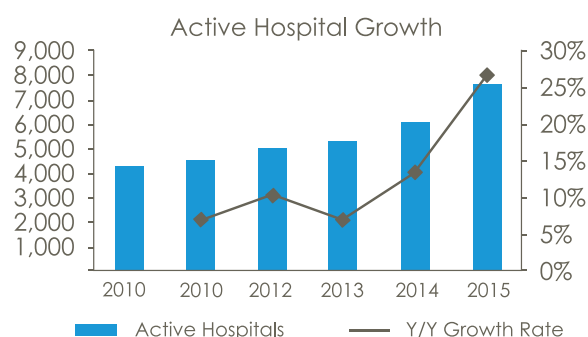
implementation costs, but on a much smaller scale. Our rollout of the system is ahead of our original deployment plan. We ended 2015 with Trupanion Express™ installed in over 500 veterinary hospitals — 150 more than our initial projections. In the last six months of 2015, we paid over 25% of veterinary invoice dollars directly to veterinarians. I am very proud of this achievement.

I am also very proud of our achievements related to our Territory Partner training and support programs in 2015. We are continually improving in this important part of the business. We ended the year with 84 Territory Partners, which was one short of our target for the year. In 2015, our Territory Partners made over 86,000 face-to-face visits with veterinarians and their staffs in over 19,500 veterinary hospitals throughout North America. As a result, we increased our active hospital<sup>8</sup> count in 2015 to 7,660 — a 26% increase from 2014.

As the acceleration of our active hospital base shows, our Territory Partners are becoming increasingly effective. This growth is even more significant, considering that the vast majority of our Territory Partners operate in relatively “new territories” where they have been building relationships for fewer than 3 years. A typical territory or market has approximately 2 million humans, 1 million cats and dogs, and 250 veterinary hospitals.

In our more established markets (over 5 years), approximately 50% of hospitals are active. Considering the quality of our field representatives today, I am confident that our less established Territory Partners will be increasingly successful as we continue to give them resources and support. Here is another way to think about it — if all of the 19,500 veterinary hospitals that we currently visit were in more established markets, we would expect to have close to 10,000 active hospitals. That is consistent with our current active hospital growth rate, as shown in Figure 1.

Figure 1.



## Opportunities for Improvement

2015 was a good year, but it was far from perfect. We made some mistakes and in hindsight, we should have done a few things differently.

The first area for improvement is the onboarding of new colleagues. While we are excited about the new additions to our team in 2015, we could have done a better job training them. Our company is unique, and it takes time to understand what we do. We can serve our new colleagues better if we spend more time upfront educating them on our business as a whole. In 2016, we will leverage the Tru-University program that we developed for our Territory Partners and extend it to our new and existing team members. I am confident this effort will more than pay for itself over time.

The second area of concern is our lack of execution educating pet owners about the benefits of Trupanion’s approach and our value proposition compared to our competition. We know we have the highest value proposition in the industry, but I’m not sure how effectively this message is communicated to pet owners (unless perhaps they talk to a veterinarian at one of our active hospitals). I expected greater progress on this front in 2015, and it will be an area of increased focus in our 2016 marketing efforts.

The third area I would like to focus on improving this year is related to our LVP:PAC ratio in each of our pricing sub-categories. Overall we have been close to hitting our 5:1 LVP:PAC target, but within some of our sub-categories we have not been as accurate or focused on hitting this target ratio. There are some categories in which we are simply mispriced, while in other categories we haven’t been as accurate in managing our acquisition spend in relation to the lifetime value of those

pets. Said another way, categories with a higher lifetime value allow for higher acquisition spend, while categories with a lower lifetime value should reflect the same discipline. In 2016 we will spend more energy improving our accuracy in this area.

The fourth area that could improve is our fixed expenses. I take full responsibility for not being more aggressive in this area. If a do-over were possible, we would have targeted a lower spend in our fixed expenses in 2015. Our 2016 budgets reflect these learnings.

## Growth Strategy

Turning to our strategy, our goal is to deliver consistent, long-term growth.

The North American market penetration remains low, so the opportunity for growth is, and will remain, huge. We have been grabbing 40% of revenue growth in North America and are poised to maintain category leadership in

the future. Our central team of data experts drive business decisions by consistently analyzing our proprietary data and extracting insights to drive efficiencies. They optimize pricing to provide ultimate value to pet owners, maintaining our commitment to pay out 70% of the revenue we receive to the average pet owner within a sub category. Sub category specific pricing ensures that all of our members receive the same value proposition regardless of whether they pay \$20 or \$200 per month.

In the coming year we will focus on adding more active hospitals and then increasing same-store sales in those hospitals. In addition, we will reinvest our efforts to build brand equity and increase conversion rates and leads, while remaining disciplined to our LVP:PAC ratio. This is the same strategy we have consistently pursued for 8 years in the United States and for 16 years in Canada.

Figure 2 shows our revenue by cohort year, which illustrates the impact of member

Figure 2.

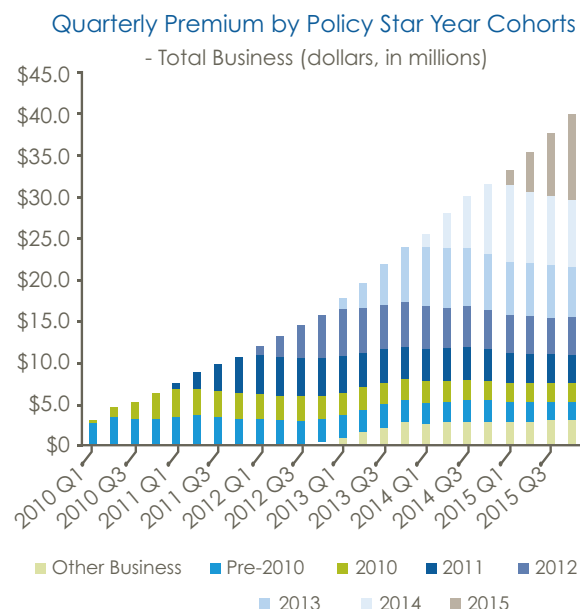
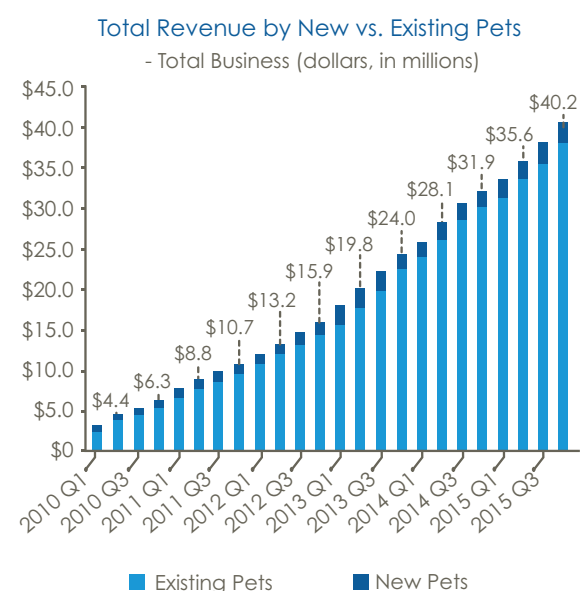


Figure 3.





satisfaction and retention on our revenues year over year.

By continuing to relentlessly execute on this strategy, we are confident that we will have continued growth for decades. Figure 3 shows our total revenue growth by new versus existing pets since 2010.

It's also important for us to know whether our members are becoming more loyal over time. Figure 4 shows our retention by cohort year, which suggests to me that our efforts to continually increase our value proposition are working, as our members are becoming increasingly loyal over time. If this trend continues and we keep improving in our execution, it bodes very well for our business. In particular, our loyal members are prone to enroll more pets and encourage their friends and family members to do the same.

The equivalent of obtaining the Holy Grail, or nirvana, for a monthly recurring subscription business is to have the existing member referrals equal or exceed the number of members who cancel. In Trupanion's case, our subscription business has averaged a 98.5% monthly retention rate over the last 5 years. Over the last 2 years, this monthly average

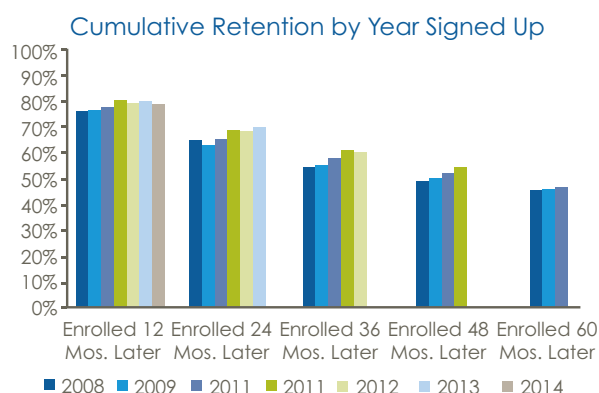
has crept as high as 98.7%, leaving us with a 1.3% churn rate each month. If the proverbial "hole in our boat" is 1.3% of pets cancelling or passing away each month, it would be exceptional if 1.3% of our new pets organically subscribe to our service through existing members adding a new pet or friend referrals.

The better our value proposition and customer experience becomes the more we expect to see our loyalty additions grow. Over the last few years, we have seen this combination rise to 0.7% of our total subscription pets each month. We are getting close to the 1.3% "nirvana" mark, but we still have a 0.6% gap versus our long-term target. However, that is not the whole story...

Trupanion saw an average revenue per pet (our version of ARPU) growth in same currency of 6% in the US and Canada over the last 5 years. Assuming 6% as a proxy for the average annual increase, the monthly impact is about 0.5% ( $6\% \div 12 = 0.5\%$ ). This means that on a monthly basis, I believe we are about 0.1% away from a state of revenue neutrality, whereby pets who are added to our book of business (with little to no cost to acquire them) combined with consistently increasing ARPU from our new pets and/or existing pets almost equals the revenue lost from pets who cancel or pass away.<sup>9</sup>

When I have mentioned this fact to some people before, they have responded by asking, "How is that possible?" Let me explain: Our pet acquisition cost (PAC) is our total net acquisition cost for a period of time divided by the number of newly enrolled pets. Our PAC has virtually zero expenses associated with servicing or maintaining our existing members. All expenses for servicing our existing members are intended to be captured in our variable expenses, which includes our Territory Partners' residual commissions. As a result, if we wanted to operate the business on a revenue-neutral basis to gain leverage in our bottom line, we anticipate that the theoretical

Figure 4.



PAC costs would be the relatively small expenses associated with conversion costs of adding the 0.7% new pets per month, offset by our new member sign-up fees.

If some day our monthly churn equals the percentage of pets added by existing members plus member referrals, we could be in a position to grow our company at virtually zero cost, if we so choose. More specifically, we could cut our PAC costs to include only conversion costs (which would be largely offset by sign-up fees), and our revenue and cash flow would still grow at the rate of price increases. As discussed above, annual price increases are currently 6%, with no signs of slowing down.

## Looking Ahead

As the CEO of Trupanion, it is my responsibility to create wealth for our shareholders while solving a large problem for our members, building moats around our business, and aligning the interests of all of our constituents. I believe we can best accomplish these goals if we continue our progress in these four areas:

1. Adding more responsible, loving pet owners to Trupanion's book of business;
2. Building relationships and trust with more veterinarians and their staff;
3. Enhancing the customer experience; and
4. Reducing our fixed expenses as a percentage of our revenue, so that we can continue to expand our adjusted operating margin.

As we expand our margins, we must also diligently grow our pet base. As I said at the outset, this means focusing on a 5:1 LVP:PAC ratio. We operated slightly below this level in 2015, but we believe our long-term target remains achievable.

## In Conclusion

The team truly rallied in 2015, and we remain as excited as ever about the future. I've said in the past that we are on mile 3 of a marathon, but after this year, we've moved to mile 4.

I appreciate that this letter includes more numbers than you may be accustomed to seeing, but we strive to find long-term focused shareholders who understand our business on a deeper level. We are confident that these shareholders will be aligned with our values and best positioned to benefit from our strategy. If you are an investor who is new to our story, I encourage you to take the time to learn more about Trupanion and welcome you to come visit our team in Seattle.

For those current shareholders who have already dug into our business and placed their trust in us... thank you.



Darryl Rawlings  
*Founder & Chief Executive Officer*

<sup>1</sup>“Fixed expenses” are comprised of our general and administrative expenses and our technology and development expenses, less depreciation and stock-based compensation expenses.

<sup>2</sup>Adjusted operating income is our non-GAAP metric of operating profit before sales and marketing. This previously was referred to as “discretionary margin.” As a percentage of revenue this is referred to as “adjusted operating margin.”

<sup>3</sup>In this letter and our other publicly available reporting, we use certain non-GAAP measures. We believe it is important to view these non-GAAP measures as a complement to our financial statements; however, these measures are not a substitute for, or superior to, measures of financial performance prepared in accordance with GAAP, which appear in the accompanying annual report. These measures also may be different from, and inconsistent with, non-GAAP measures used by other companies. For reconciliations of these measures to the most comparable measures calculated under GAAP, please refer to our Investor Relations website under the Quarterly Earnings tab.

<sup>4</sup>“Variable expenses” are comprised of our costs of revenue other than claims (i.e., member service expenses, renewal fees to our independent referral network, credit card transaction fees and premium tax expenses) less stock-based compensation expenses.

<sup>5</sup>Excluding stock based compensation.

<sup>6</sup>Acquisition cost, adjusted operating income, adjusted operating income margin and adjusted EBITDA are non-GAAP measures that we use to evaluate our performance. Acquisition cost is our sales and marketing expense before stock-based compensation expense. Adjusted operating income (historically referenced as discretionary income) measures our operating loss before acquisition cost, other stock-based compensation expense and depreciation and amortization, while adjusted operating income margin (historically referenced as discretionary margin) is adjusted operating income expressed as a percentage of total revenue. Adjusted EBITDA is net loss excluding stock-based compensation expense, depreciation and amortization expense, interest income, interest expense, change in fair value of warrant liabilities and income tax.

<sup>7</sup>As a reminder, lifetime value of a pet (LVP) is calculated in part based on gross profit from our subscription business segment for the 12 months prior to the period end date excluding stock-based compensation expense related to cost of revenue from our subscription business segment, sign-up fee revenue and the change in deferred revenue between periods, multiplied by the implied average subscriber life in months. Implied average subscriber life in months is calculated as the quotient obtained by dividing one by one minus the average monthly retention rate. We monitor LVP to assess how much lifetime value we might expect from new pets over their implied average subscriber life in months and to evaluate the amount of sales and marketing expenses we may want to incur to attract new pet enrollments. Pet acquisition cost (PAC) is calculated as net acquisition cost divided by the total number of new pets enrolled in that period. Net acquisition cost, a non-GAAP financial measure, is calculated in a reporting period as sales and marketing expenses, excluding stock-based compensation, offset by sign-up fee revenue and other business segment sales and marketing expenses. We offset sales and marketing expenses with sign-up fee revenue since it is a one-time charge to new members used to partially offset initial setup costs, which are included in sales and marketing expenses. We monitor average pet acquisition cost to evaluate the efficiency of our sales and marketing programs in acquiring new members and measure effectiveness using the ratio of our lifetime value of a pet to average pet acquisition cost.

<sup>8</sup>Recall that “active hospitals” is the number of hospitals to which we’ve attributed a new enrollment within the past 90 days.

<sup>9</sup>To Show Our Work, this is calculated as follows: 1.3% canceling each month - 0.7% “loyalty additions” - 0.5% monthly ARPU increases = 0.1%. Here, ARPU refers to our monthly adjusted revenue per pet or “ARPP.”





trupanion®  
2014 ANNUAL REPORT

# TO OUR SHAREHOLDERS

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*2014 ended with our 1,000,000th veterinary invoice being paid after a member's pet, a mixed breed dog named Marlee, became sick. We enrolled our first pet in 2000, and a lot has changed since then, yet it is humbling to recognize that our mission is as applicable today as it was when I started the company – arguably more. In Marlee's case, she required only \$13.18 of medication to solve her problem, but over the years we have seen other members' pets pass \$30,000 and \$40,000 in paid veterinary invoices. No claim is too big or too small for Trupanion!*

As this is our first shareholder letter as a public company, I would like to take this opportunity to provide a better understanding of how we at Trupanion operate and think.

By the end of this letter, I hope you will understand that not only do we care about creating shareholder wealth, but we truly care about our shareholders as integral team members. Our plan now includes achieving free cash flow positive by the end of Q2 2016. In the next five years, we plan to achieve scale, which we define as 650,000-750,000 pets. At scale, our target is to have 5% fixed expenses and a 15% discretionary margin from our subscription business (before sales and marketing), with our discretionary income funding all our growth, including our capital requirements. This may be aggressive, but I commit to updating you on our progress toward these goals every year. If you are already an investor, I hope you feel comfortable with your decision. If you are not yet a shareholder, I hope you consider adding us to your long-term portfolio.

In our view, the role of a publicly-traded company is to create shareholder wealth by solving a large problem with a unique and defensible solution while aligning the interests of all of our constituents. Our constituents include responsible, loving pet owners; veterinarians and their co-workers; Trupanion Territory Partners; Trupanion employees; and Trupanion shareholders.

## The problem Trupanion is solving

Pet owners in North America spent \$55 billion caring for the 180 million dogs and cats last year, and that number is expected to increase in 2015. Responsible, loving pet owners understand how to take care of their dogs and cats. We exercise them, play with them, feed them high-quality food, and make sure they receive preventive health care like flea control, dental cleanings, and annual checkups. They sleep in our bed and on our couches, we use them as our screen savers — and we spent \$500 million dressing them up for Halloween last year. But, most of all, we love them as they love us... unconditionally.

Where we as responsible pet owners struggle is when they become sick or injured. We know where to go for help - our trusted local veterinarian. But we stress over budgeting and planning for the cost of that veterinary care.

“...RESPONSIBLE, LOVING PET OWNERS — DO NOT WANT A RETURN ON INVESTMENT. NOBODY IN THEIR RIGHT MIND WANTS THEIR PET TO BE ‘UNLUCKY’ OR EVEN ‘AVERAGE.’”

Why is this such a challenge? A few reasons:

1. We have no idea if our pet is going to be “lucky,” “unlucky,” or “average.”
2. Accidents and illnesses do not occur at convenient or predictable times.
3. The local cost of veterinary care varies by a wide margin by hospital and an even wider margin if you include referral, specialty and 24-hour emergency hospitals.
4. The risk profile of each cat and dog is very different.
5. Large veterinary invoices now can cost \$10,000, \$20,000, \$30,000 — up to \$40,000; therefore scrambling for a credit card is no longer a viable option.

Trupanion solves these problems by sharing the risk equally between the “lucky,” “unlucky,” and “average” dog or cat, taking into account the local cost of veterinary care, and the risk profile of the pet.

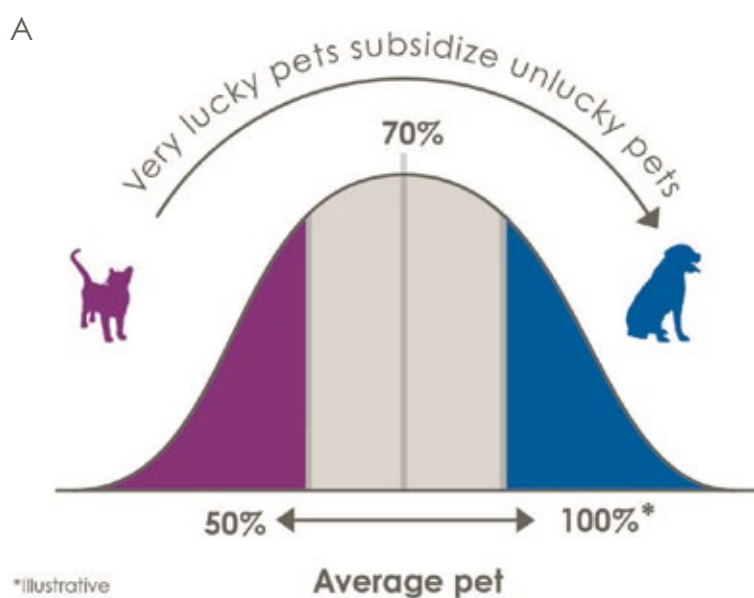
These factors allow us to create “price” categories - over 1.2 million price categories last year. These categories are designed to let us share risks equally and fairly among the “lucky,” “unlucky,” or “average” dog or cat. For example, one category is “Golden Retrievers,” another is “dog residing in Santa Barbara,” and a third is “cats enrolling at the age of six.”



We do not try to predict the future. Our responsibility is to understand the costs associated with each category and its underlying trend, and then add a 30% margin. This “cost plus” approach allows us to pay 70 cents on the dollar to the “average” pet owner over the life of their pet (see graph A).

It is important to note that our members - responsible, loving pet owners - do not want a return on investment. Nobody in their right mind wants their pet to be “unlucky” or even “average.” Our members say, “I hope we never need to use Trupanion, but I feel better knowing that if we do, Trupanion will do what they say.” Stop and think about this for a minute... maybe three minutes if you are not a pet owner.

A



## Defensible solution

We believe that we have a unique long-term defensible solution. It starts and ends with being the low-cost operator, meaning that our cost to administer and the cost to acquire new members are lowest in North America and very difficult for any existing or new company to emulate. This does not mean that our product will be cheapest in the market; it means that we have the ability to consistently use a higher percentage of our members' monthly subscription fees toward paying veterinary invoices (see graph B on next page).

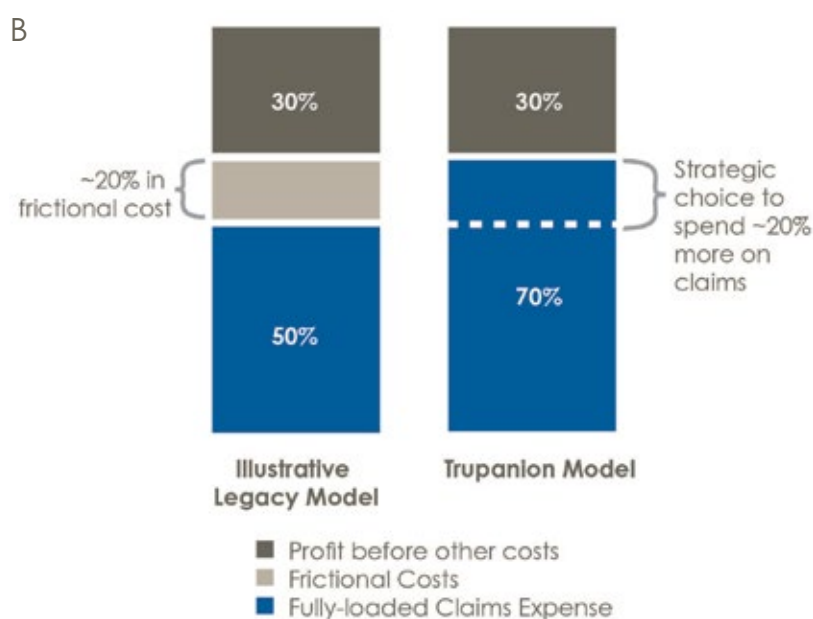
To be completely fair and transparent, it is our underlying costs that are low today. Similar to OpenTable when they went public, our costs in an existing, established market are low. In new



"OUR PROPRIETARY DATABASE HAS BEEN BUILT OVER 15 YEARS USING OVER 7.5 MILLION PET MONTHS OF INFORMATION AND INCLUDES OVER 1 MILLION CLAIMS."

markets, until we reach scale, the cost of acquiring new pets will be higher. Likewise, our fixed expenses, which include our G&A and our technology investments, will run higher for the short term as we invest ahead of scale to be the long-term category leader.

Trupanion's proprietary data has given us a unique advantage in the marketplace. We have a central team of analysts of varying backgrounds (actuary, finance, math, engineering) who serve as the "truth department" and support all areas of the business. They provide transparency into company data for better decision-making and use advanced techniques to extract insights from this data. Our proprietary database has been built over 15 years using over 7.5 million pet months of information and includes over 1 million claims. Pricing accurately allows us to share our high value proposition with each pet owner. We are confident that we lead the industry with our data analytics. Knowing what I know today, it would take me over 13 years to replicate our 15 years of data.



One of the biggest differentiators for Trupanion is our unique approach to the market through a field team we call Territory Partners. We fundamentally believe that support from veterinarians is critical to driving broader acceptance of medical insurance for pets in North America. We have built our success around this belief, making pet owners aware of our solution by using Territory Partners to educate veterinarians, and encouraging them to actively recommend Trupanion in their hospitals. Territory Partners build relationships and trust with veterinarians as the local face of Trupanion. In 2014, we estimate that we made over 80,000 face-to-face visits. Over the last 15 years we've made hundreds of thousands of visits with veterinarians.

At the end of 2014, we had 70 people in the field and we expect to have 85 by the end of 2015. We ended 2014 with over 6,000 active hospitals, compared to over 5,000 active hospitals at the

C

## Trupanion's Territory Partner Model



end of 2013. An active hospital is not a hospital that displays our brochures, but a hospital that has had a pet enrolled over the previous three months.

This approach is effective at creating members and efficient from a pet acquisition cost perspective (see graph C).

In order to maintain these important veterinary relationships, we are consistently looking for ways to enhance the Trupanion experience in the hospital. Trupanion Express™ is our no-cost software solution that revolutionizes the member experience and removes a major barrier — the reimbursement model — that has historically existed between “pet insurance” providers and veterinarians. For pet owners, their 90% coverage through Trupanion is paid directly to the veterinarian at the time of invoice — dramatically reducing out-of-pocket costs. For veterinarians, Trupanion coverage enables them to move forward with “plan A” care for any sick or injured pet while growing their top and bottom lines. In the process,

Trupanion collects additional proprietary data to further improve our pricing accuracy, while maintaining a strong relationship with supportive hospitals. At the end of 2014, we had approximately 175 of our 6,000 active hospitals using Trupanion Express™. These hospitals are among our most active, representing over 20% of our claims dollars. While still early, following implementation, we’re seeing improved referral and conversion rates. Longer term, we also expect this to aid retention rates (see graph D on next page).

Data analytics, expansion of our Territory Partner sales force, and focus on Trupanion Express™ are all strategic investments aimed at scaling our business and driving the penetration of medical insurance for pets north of the approximately 1% it is today in the United States and Canada.

## Aligning the interests of all of our constituents

Responsible, loving pet owners want a solution to their underlying problem of budgeting for the costs of veterinary care if their pet becomes sick or injured. They demand coverage for the medical issues most likely to occur to their pets. They want to use their veterinarian of choice and to have 90% of the actual invoice paid directly to their veterinarian so they do

not have to come out of pocket and suffer through a cumbersome reimbursement model. They do not want to be penalized if their pet becomes “unlucky.” Most importantly, they want value. Unfortunately, pet owners were not seeing these things offered in the traditional products available on the market.

From day one, I have been dedicated to meeting these needs and today we offer a superior product that is inherently different than what

D



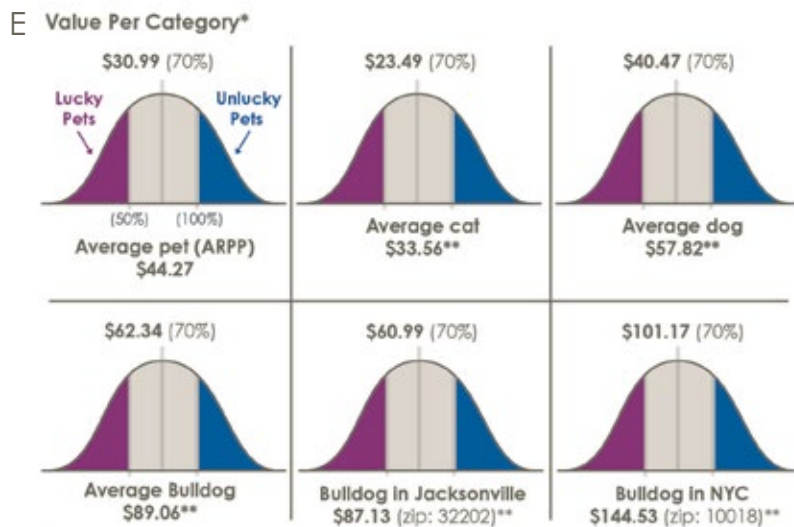
“THE VALUE OF THE TRUPANION SOLUTION COMES IN THE FORM OF PAYING THE INDUSTRY’S HIGHEST SUSTAINABLE PERCENTAGE BETWEEN WHAT PET OWNERS PAY IN THE WAY OF MONTHLY COST AND WHAT WE PAY IN VETERINARY INVOICES FOR THE ‘AVERAGE PET.’”

pet owners perceive as pet insurance in North America. In fact, we do not describe ourselves as “pet insurance” — we are medical insurance for cats and dogs. Why is that? Each pet owner you meet will have a different perception of what “pet insurance” is — wellness-only coverage, accident-only coverage, an HMO-like product that restricts where you can get care, fee schedules that restrict how much care you can receive, and unequivocally all reimbursement-based.

We clearly solve all of these problems — and more. We cover hereditary and congenital conditions (those things most likely to happen to a pet), we don’t raise rates because a pet has claims, we have no payout limits, and we’re eliminating the reimbursement model with Trupanion Express™. The value of the Trupanion solution comes in the form of paying the industry’s highest sustainable percentage between what pet owners pay in the way of monthly cost and what we pay in veterinary invoices

for the “average pet.” This is a strong value not only for the pet owner — but for the veterinarian and the pet as well. We’re aligning the interests of the pet owner and the veterinarian, allowing both parties to focus on providing the best care, rather than the cost.

I would like to draw a comparison between Trupanion and another subscription membership company that I greatly admire. Costco members inherently understand if they are purchasing a 60” flat screen, a bottle of Bordeaux, a can of tuna, or a roll of toilet paper, that they are always getting the best deal. Trupanion members need to know that whether they are paying \$33/month for their cat or \$144/month for their Bulldog, they are getting the industry’s best deal, for a product that works, and from a company they can trust (see graph E).



\*Illustrative.

\*\*Assumes 2-year old pet selecting a \$100 deductible

## Let's have a discussion about veterinarians, the cost of veterinary care and our philosophy around these items

Trupanion has been built from the ground-up based on our relationships with veterinarians and their staff. They are extremely loyal and consistent once we earn their trust. Veterinarians and their staff chose their occupation because they love pets. Getting into veterinary school can be more difficult than getting into medical school or dental school. Yet veterinarians earn considerably less than their counterparts on the human side.

The delivery of veterinary medicine is thriving. There are 28,000 veterinary hospitals across North America and approximately 26,000 are independently owned. They are extremely efficient, providing the same surgeries, medicine, diagnostics, and hospitalization as their human counterparts at a fraction of the cost. The costs of veterinary care are market-driven due to such a high percentage of independent hospitals serving the needs of their local pet owners in a way that sets their hospital apart from the competition down the street or around the corner. Veterinarians are also highly respected within their community, often rated among the highest professions alongside medical doctors and pharmacists.

Understanding the motivations, values and perspectives of veterinarians and their staff is critical to our long-term success. They do not want their industry screwed up like the human side. This means no to any HMO-like models. Having insurance companies drive the pricing of care or selection of hospital is not acceptable. They want to serve their clients' needs, not waste their time on filling out forms. They know the difference between a high-quality product and one that has limitations and exclusions. They understand what appropriate care is and are passionate about providing it. Compassionate euthanasia is a part of veterinary medicine, and will always be a part of veterinary medicine; but economic euthanasia is heartbreaking to all veterinarians and their staff. Finally, they agree that medical insurance for cats and dogs is for catastrophic issues, not wellness or routine care.

Trupanion's product pays 90% of the veterinarian's actual invoice for all diagnostics, surgeries, medications, and hospital care. We have no payout limits - period. We do not penalize pet owners if their pet becomes sick or is injured. We cover all medical conditions that arise after a pet owner gets Trupanion; this includes the things most likely to occur to their pet's breed, known as congenital or hereditary conditions. Trupanion has only one simple plan, so it is easy for veterinarians and their staff to understand and therefore explain to their clients. Trupanion has the ability to integrate with the veterinarian's practice management

"WE ARE NOT TRYING TO CONTROL THE COST OF VETERINARY CARE; WE ARE SIMPLY TRYING TO UNDERSTAND THE COSTS FOR THE AVERAGE PET IN EACH CATEGORY, AND ADD A 30% MARGIN."

software, so we replace cumbersome paperwork with a couple of clicks and the ability to pay the veterinarian directly.

We are not trying to control the cost of veterinary care; we are simply trying to understand the costs for the average pet in each category, and add a 30% margin. This makes the budgeting manageable to the responsible, loving pet owner.

## Why our values are so important

Trupanion employees love pets. On an average day in our Seattle office we will have about 400 employees working alongside 200+ dogs and cats. This is an important part of our culture, as our four-legged friends constantly remind us why we come to work. To ensure the comfort of all the pets, we have full-time dog walkers. Our average employee has years of experience in veterinary hospitals, shelters, doggy day cares or other related fields. Similar to the demographics of a veterinary hospital, we have a high percentage of female employees between the ages of 24 and 40. In January, to supplement our dog walking services, we launched a child care center for our employees with two-legged children under the age of three.

Another Seattle company that we admire is Starbucks and in particular their values on "social conscience." We at Trupanion believe

that our environment and values are critical to our long-term success. We feel strongly that everyone at Trupanion is equally important; we all have the same size desk and the same benefits regardless of whether we are hourly or salaried or our tenure with the company. We want everyone to be fulfilled and comfortable being themselves. We have a sign on our wall that shows the Oscar Wilde quote, "Be yourself, everyone else is taken" and we take that motto seriously.

Our values are not something we put on marketing materials - they are beliefs or traits that are shared by our community and define our culture. We believe that the values of a company are similar to the characteristics of an individual. If you were to describe a friend to a co-worker you may use words like smart, funny, loyal, and crazy. The combination of these words would paint a picture to your co-worker about your friend. If a pet owner or veterinarian describes Trupanion in a way that lines up with our values, then we have the underpinning of a Brand. Our values are:

- We do what we say
- Simple is better
- We do not punish unlucky pets
- We're innovative and fair
- We love pets!

Our values are listed in the order of priority — if someone loves pets, but they do not do what they say? That individual does not belong at Trupanion.



## Shareholders have been with us since the beginning

I started Trupanion 15 years ago in Vancouver, BC. From the beginning, I have had shareholders. For the first few years the company was bootstrapped with my personal proceeds earned from the sale of my cigar business, and from the trust of eight individuals who invested \$25,000 each. Several years later, and before taking on any institutional investors, we agreed to pay \$35,000 to each of the eight individuals and they kept 100% of their shares. It was very important then, as it is today, to repay shareholders and to do what we say.

Our commitment to our institutional investors was to take our learnings from our first seven years in Canada and to create and build a category for medical insurance for cats and dogs in the United States & Canada. In 2008, we said that we would build relationships with veterinarians, get the underpinnings of a consumer brand, expand upon our data, focus on the consumer experience, and take the company public in 2014.

On July 18, 2014 we took Trupanion (TRUP) public on the New York Stock Exchange and embarked life as a public company.

## 2014 performance

First, an overview. While becoming a public company was a major milestone, it was truly only one moment in time for us. We had a full year of hard work, accomplishments, and setbacks. I believe we did several things well and several things poorly in 2014, and I'll outline them here.

**In the negative column**, we disappointed ourselves and others by having a pricing miss in Q3 & Q4, which was outside of our allowable tolerance and affected our gross margin. For this miss I blame myself. For several years we had been extremely accurate at our pricing, so much so that I became overly confident and focused on weaker areas of our business.

Primarily, I focused on improving the quality, selection and training of our national sales force of Territory Partners (an area we began to fumble in 2012 and 2013), as well as preparing to take the company public. What I didn't account for during this time was the speed in which the company was able to execute change in processes. I had a flat organizational structure and unfortunately I was a critical component in disseminating information across departments. Said another way, the impact of the way we were changing our claims process was not clearly understood in our pricing department and we got surprised. The organizational structure was adjusted in the fourth quarter of 2014 and we now have five clear owners of every key metric and line item



on our profit and loss and cash flow statements. These owners meet weekly and I am no longer a barrier to the dissemination of information.

The second area where we let ourselves down was holding on to some people longer than we should have, specifically some Territory Partners who we had previously on-boarded too quickly and, to be fair to them, without enough training and tools to increase their odds of being successful. When talking about having the right people in the right seat on the bus, my experience tells me this will not be the last time we acknowledge this failure.

A third area that disappointed me was our focus on increasing enrollments and same-store sales ahead of a more foundational goal of increasing enrollments by adding more active hospitals. It would be lovely to do both well, but we mixed up the priorities last year.

**In the positive column**, we believe we raised more than enough money to carry us through to cash flow positive. We have no intention of going back to the markets to raise additional capital.

To set appropriate expectations clearly, I should caveat that if we miraculously discover a new lever that will dramatically and cost-effectively change our growth projection curve, and it requires additional capital, we will do what's best for the company and shareholders long-term. I put this miraculous new lever probability somewhere between very low and extremely low. After 15 years, we are not expecting to find a silver bullet.

Second, we have improved the hiring, training and selection of our Territory Partners. In 2014, we launched a program we call "Trupanion University" where current and prospective Territory Partners participate in an extensive three-week training on Trupanion.

Third, we have significantly advanced our knowledge, product and processes to allow us to improve our member experience, facilitating our long-term goal of paying veterinarians directly and eliminating the cumbersome reimbursement model. Trupanion Express™ is very important to our long-term ambitions and in 2015 we intend to learn much more to ensure we get the full impact when we are eventually deployed throughout North America.

## Let's move on to the numbers

We are not at the stage where I can start talking about earnings per share. What I can go over is the top line, bottom line, and some of our key metrics. But first, it's important to understand how we think about our business metrics internally. We use the old-fashioned cash flow method.

We collect cash at the beginning of the month, and then pay veterinary invoices, variable expenses to support member service, taxes and fees, and fixed expenses in the way of technology and general and administrative expense (G&A). The remaining cash, before sales and marketing, is what we term our "discretionary income." We can choose to

spend this discretionary income to acquire new members, invest in foundational one-time initiatives, re-purchase shares, or one day, distribute to our shareholders.

Please note our discretionary income is not recognized by GAAP accounting or the SEC, but we certainly are not the first direct-to-consumer subscription company that thinks about their business this way. John Malone and TCI (the cable company) in the late seventies introduced the investment community to the term EBITDA when they needed to describe cash flow in their business in lieu of earnings per share. TCI shareholders were well rewarded when they educated themselves in how they managed their business based on cash.

It should also be noted that the discrepancy between our actual cash flow and GAAP accounting for revenue is approximately 200 basis points in the positive direction. The two-point swing is related to the requirement to defer approximately half of a month's revenue forward one month as our members pay on differing days during the month and receive a month of coverage.

Back to the GAAP accounting and other key metrics in 2014:

- Revenue was \$116M
- AEBIDTA was a loss of (-\$10M)
- Free cash flow was (-\$16M)
- Adjusted Revenue Per Pet (our version of ARPU) was \$44 per month

- PAC was \$119 (pet acquisition cost)
- LVP was \$590 (lifetime value of a pet)
- LVP/PAC was 5.0X
- Discretionary income was \$3M

All the above key metrics, excluding fluctuations in foreign exchange rates, were at or slightly ahead of analyst consensus.

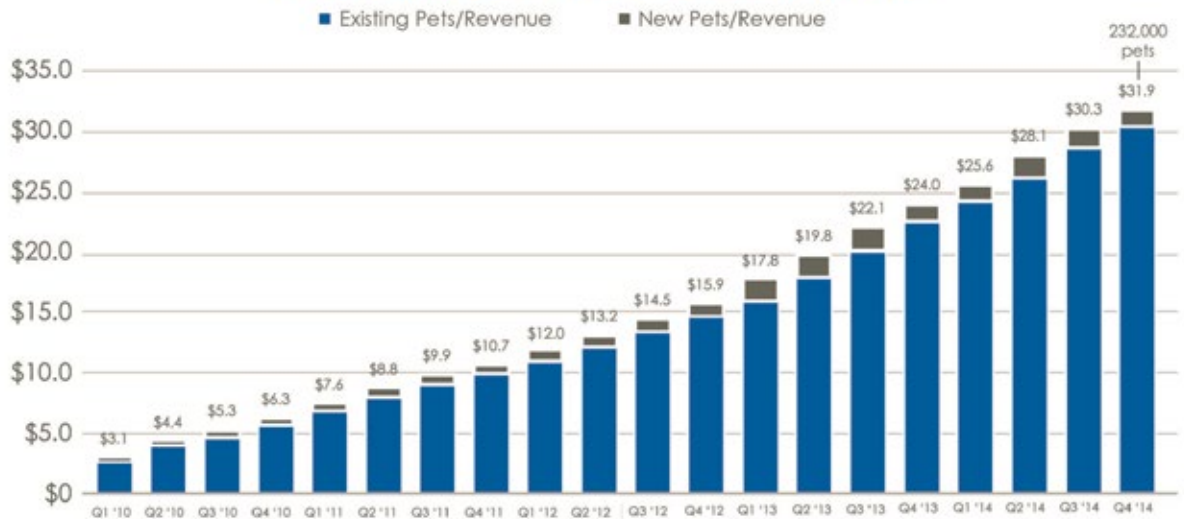
## Notable milestones in 2014

- 2014 showed continued revenue and pet growth (see graph F on page 14).
- We added 213 people to our home office team — that is 44% growth over 2013. We also welcomed 67 new pets to the office, making our Trupanion family now a total of 227 pets and 413 employees— a 1:2 pet to human ratio.
- We launched the US Veterans Service Dog Program, working with the US Department of Veterans Affairs. Through this program, approved veterans' service dogs receive quality veterinary care and Trupanion covers 100% of all coverable expenses — this includes treatment for pre-existing conditions and wellness and preventive exams, as well as everything covered for Trupanion's members. This program shows up in our "Other Business" section of our P&L.

- Our Member Care team initiated a new partnership with Aspect, a workforce management solution, to help deliver exceptional service. Aspect allows Trupanion members to move from channel to channel and connect to the same team member. Almost overnight, Trupanion shaved 30 seconds off average wait times by leveraging skills-based routing. Aspect technology has also helped Trupanion improve timeliness of email responses and stay within service level goals.
- We made our stock market debut on the New York Stock Exchange. Several team members traveled to New York City to ring the closing bell. The traditional celebratory dinner was held picnic-style in Central Park while we dined on Shake Shack burgers. The rest of the office partied at home with champagne and cupcakes. Our stock opened at \$10 per share, and we raised \$82 million.
- We launched our new website — a robust, fully responsive, world-class web platform and what we believe is the best possible ‘front door’ for Trupanion. After its launch, The Interactive Media Council named Trupanion.com the winner of the 2014 Interactive Media Award for Best in Class Website.
- We hosted a three-day conference in downtown Seattle for our Territory Partner sales force. The conference featured keynote speakers Richard Galanti, Costco CFO; Howard Schultz, Starbucks CEO; David Loewe, Seattle Humane Society CEO; and Kristin Hamilton, Koru CEO.
- Our Chief Technology Officer, Craig Susen, was awarded the CTO of the Year Innovator Award.
- Through our Member Donation Program, our members donated over \$104,000 to charities across the United States and Canada. These charities include The American Humane Association, National Canine Cancer Foundation, The Farley Foundation, and the BC SPCA Biscuit Fund. We also donated 9,107 pounds of pet food to the Seattle Humane Society in our annual pet food drive and sponsored 19 children in need for the holidays.
- Our Child Care Center hosted its open house. The center is available to Trupanion employees at no cost, and serves children aged 6 weeks to 2.5 years. The Child Care Center was officially opened January 5.
- We ended the year with 232,000 enrolled pets, 70 regional sales people in the field and 6,073 active hospitals.

F

### Total Revenue by New vs. Existing Pets\*



\*All revenue amounts reflect adjusted revenue, in millions. For a description of how we calculate adjusted revenue, see "Management's Discussion and Analysis of Financial Conditions and Results of Operations — Non-GAAP Financial Measures." Existing Pets/Revenue reflects adjusted revenue from subscription pets who had active subscriptions at the beginning of the quarter and recurring adjusted revenue from our other business segment. New pets/revenue reflects adjusted revenue from subscription pets enrolling during the quarter and adjusted revenue added during the quarter from our other business segment.

## Our business model

Our business model is simple. But the execution of our business model is challenging. It requires focus, years of data, and a great team.

Our business model is similar to the cable industry in the 1960's, the cellular industry in the 1980's, and more recently, two companies we admire - Netflix and Pandora. Purely, we are a direct-to-consumer monthly subscription service.

Subscription service companies rely on a high value proposition for their members, something they feel and value. The best subscription companies have a high cost of goods, an exceptional member experience, and the lowest frictional costs.

The model is to spend X to acquire a new member and to have the discretionary income return substantially more than X over the life of the subscription. Margin percentages are less important than the amount of free cash generated over the life of the subscription. One

"OUR BUSINESS MODEL IS SIMPLE. BUT THE EXECUTION OF OUR BUSINESS MODEL IS CHALLENGING."

of our key metrics is our PAC/LVP ratio, which all quality subscription companies understand. Internally, we think the PAC/LVP ratio is a little overstated as it uses the average contribution dollar and omits the cost of our fixed overhead. It is useful to show the potential before we are fully at scale and that is why we report it, BUT it is flawed because it does not account for the cash required to operate our fixed expenses.

For these reasons, we are most concerned with the internal rate of return (IRR) for incrementally adding an average pet. We calculate the IRR by understanding our cost to acquire an average new pet and the free cash flows that we anticipate will be generated over the average pet's life. We have previously stated that, at operational scale (650,000 to 750,000 pets), our target fixed expenses should equal 5%-6% of revenues. If we are able to achieve a consistent 70% gross margin, 10% variable expenses and 5%-6% for fixed expenses, our discretionary margin would be 14%-15%. In the

next few years and before hitting scale if we can achieve 7%-8%, our IRR should be in the neighborhood of 40%-50% (see graph G).

Unfortunately, we do not have a 40%-50% IRR for the average incremental pet today. Candidly, we have taken a temporary step backward in the last two quarters with our inadequate pricing and our currently outsized fixed expenses. That being said, we believe that these results are achievable based on our performance in more mature markets. Lots of execution ahead!

Please remember we have over 1.2 million price categories where we monitor our PAC/LVP and therefore our IRR by category. They will not have the same results. As we try to accelerate some channels and categories, some will scale well for a long time, others will have diminishing returns. It is our responsibility to understand when to put our foot on the accelerator, when to coast, and when to slam on the brakes.

G

Months	68	Next few years									
Churn	1.47%	year	0	1	2	3	4	5	6		
LVP	570	Months	6	12	12	12	12	12	2	68	
LVP/PAC	5X	DM	\$24.35	\$48.71	\$48.71	\$48.71	\$48.71	\$48.71	\$8.12		
DM	8.1%	PAC	-\$114								IRR
ARPU	\$50.11	FCF	-\$89.65	\$48.71	\$48.71	\$48.71	\$48.71	\$48.71	\$8.12		47%

LVP = Lifetime Value of a Pet      PAC = Pet Acquisition Cost  
DM = Discretionary Margin      ARPU = Average Revenue Per Pet (Unit)

## Market comparables

Prior to and since going public we have been asked a set of questions, all with a similar theme: Why are you being covered by internet analysts? Why are you being covered by animal health analysts? Are you not just an insurance company? What are the market comparables to Trupanion?

The answer to all of these questions is that we are not easily put into a box. Our product is a catastrophic health insurance product. For this, we internally believe our challenges are not similar to a typical health insurance company and the complexity of offering our product is just another barrier to entry. We live in the animal health world, this is where 70% of the team comes from and it is necessary that we understand the needs of veterinarians and pet owners, but we are not a pharmaceutical, laboratory or distribution company. We also are not a SAAS company with a high gross margin. We are a monthly recurring revenue business that requires us to be a low-cost operator, with a high value proposition, and a focus on delivering a positive member experience with a low acquisition cost.

I have mentioned several companies in this letter that I admire, but I don't mention them to drive valuation comparisons. They inspire me, and as a business, we aspire to some parts of their business model but I am not trying to suggest they are market comparables.

Our business model is a direct-to-consumer monthly subscription service and this is how we manage the business.

## Methods of valuation

It would be disingenuous for us to talk about comparables without talking about valuation methods. My opinion on these topics probably isn't relevant to the marketplace, but I'm going to give it anyway:

- Multiple of earnings is not very relevant when a company is losing money. If investors are currently expecting/requiring dividends, we are not the right investment right now. However, as I mentioned earlier, we expect to achieve cash flow positive in the next 12 months and achieve scale in the next five years.
- Multiple of EBITDA is applicable for many growth companies if the capitalized portion of the P&L is similar to other comparable investments. We do not capitalize our growth; in fact, we capitalize only a small portion of our technology spend today and we expect this will be reducing as we scale our fixed expenses, G&A and technology to 5%-6% of revenues.
- EBITDA and GAAP puzzle me at times. If we purchased a book of business from a competitor, the purchase would be capitalized. For example, if we purchased a competitor with 50,000 pets at a price of \$300 per pet, the purchase price would be \$15 million. With GAAP accounting, the purchase would have little effect on our EBITDA and income in the year we purchased

the business, and the following year, the casual observer would only see our increased revenue from the additional 50,000 pets and the corresponding profits. Hold with me... this is where it gets interesting. If in the same year, we chose not to purchase the competitor's pets for \$300 per pet, but instead grew organically by 50,000 pets at \$150 per pet, our EBIDTA or income would have a -\$7.5M hit. EBIDTA is supposed to be a proxy on cash and GAAP accounting... well-intended as it is, it does not always lead us to the best investment decisions. The cash decision is obvious, it is better to grow organically at \$150 a pet vs. paying \$300 per pet. Needless to say, we like to manage our business based on cash.

- We are cash-in/cash-out every month. We are not a company that makes money on the float. There are insurance companies that do that very well if you are looking for a return on equity type of investment in your portfolio.
- Discounted cash flow is how we internally view our long-term strategic choices. It is purely mathematical and although the inputs of terminal growth rates and weighted average cost of capital can move the valuation all over the chart, if you keep them constant, you can determine if your choices move the needle in the right direction.

## Deployment of your capital short-term

Over the next few years we will be deploying your capital in our foundation, member experience, growth and scale. Specifically, we intend to invest in:

- Our Territory Partner program to increase the number of active hospitals recommending Trupanion. We have a long way to go to earn the trust of the 28,000 veterinary hospitals throughout North America.
- Building and deploying technologies that will improve our member experience and lower our operating costs.
- Data to improve our ability to price accurately and fairly among all of our categories. This is at the core of what sets us apart. Our members need to know that they are always getting the best deal.
- Cost-effectively adding more pets.



“WITH THE NORTH AMERICAN MARKET PENETRATION AT APPROXIMATELY 1%, WHILE WESTERN EUROPE RANGES BETWEEN 5% AND 25%, WE HAVE DECADES OF RUNWAY AHEAD.”

## Deployment of your capital long-term

As mentioned previously, we use our IRR to determine if adding an incremental pet is the best use of our shareholders' money. With the North American market penetration at approximately 1%, while Western Europe ranges between 5% and 25%, we have decades of runway ahead. Remember, at our average revenue per pet, every 1% of penetration equals about \$1 billion in revenue. If at scale we cannot get a consistent return healthier than the average shareholder, we could return the cash in the way of dividends. If we have extra capital and our share value is significantly below our discounted cash flow value, we could re-purchase shares. These are theoretical scenarios; however, I expect we will continue to see growth opportunities for years to come and continue to re-invest to capture more of the available market.

## The team

Every CEO says they have a great team. Instead of me saying it to you, I invite you to visit our Seattle office so you can meet them yourself, experience our environment, and hang out with our 200+ dogs and a few fearless cats.

Our progress to date would not have been possible without the support and cooperation from our Board. For years, Chairman Murray

Low has set the tone, leading by example with incredible character, self-awareness and drive to help build something great.

It's also important to me to call out Dan Levitan. Dan is the co-founder of Maveron, the preeminent consumer-focused venture capital firm. Partnering with Dan and Maveron has proven to be one of the best decisions that I have ever made.

I would like to take this opportunity to say thank you to:

- The amazing companies that I named in this letter: Costco, Netflix, Pandora, OpenTable, TCI, and Starbucks - thank you for being an inspiration.
- Veterinarians and your staff: thank you for believing and trusting that we could be different.
- Our employees who live and breathe our values, passionately serve our members, and have the confidence to be themselves at work.
- Our Territory Partners who day after day walk through the doors of veterinary hospitals, trying to earn their trust.
- Existing shareholders: we thank you for entrusting us with your investment.
- To those responsible, loving pet owners that have Trupanion: thank you for taking care of your buddy and choosing us. We hope you are lucky enough to never need to call us, but if you do, we will be there for you.

For those truly long-term investors who have not purchased TRUP, I encourage you to educate yourself on our company and visit our team in Seattle.


I will leave you with an excerpt of a letter a fellow board member gave to me recently:

*"I have always been attracted to the low cost operator in any business and when you can find a combination of (1) an extremely large business, (2) a more or less homogeneous product, and (3) a very large gap in operating costs between the low cost operator and all of the other companies in the industry, you have a really attractive investment situation. That situation prevailed twenty five years ago when I first became interested in the company, and it still prevails."*

Letter to Mr. George D. Young  
From Warren Buffett  
July 22<sup>nd</sup>, 1976

Thank you,

*Darryl Rawlings, Founder & Chief Executive Officer*

A handwritten signature in black ink, consisting of a stylized 'D' followed by a horizontal line extending to the right.