



trupanion™
Medical insurance for the life of your pet.

2019 Annual Report

TRUPANION.COM

Please note that this letter is intended for an audience of shareholders, team members, and veterinarians, and may include individuals who are being introduced to Trupanion's shareholder letters for the first time. In order to make this material accessible to all of these audiences, I have included plain-English intended meanings of certain terms along the sidebar. These definitions are **highlighted in green** throughout the text. These definitions differ from and are not to be confused with the technical definitions that may appear in our public filings with the U.S. Securities Exchange Commission.

I have also indicated **numbers in blue** in instances where they appear in both a description as well as in a table or an equation, to help the reader follow my logic.

To Our Shareholders

“ If we dare to understand, progress is possible in all fields, scientific, political and moral. Problems are inevitable, because our knowledge will always be far from complete. Some problems are hard, but it is a mistake to confuse hard problems with problems unlikely to be solved.

—DAVID DEUTSCH

When I first drafted this letter, we were still very early into what has evolved into a global health pandemic. I had intended to open with the following:

Trupanion's mission is simple: helping loving, responsible pet owners budget and care for their pets.

Today, our mission feels particularly relevant. Providing pet owners peace of mind in periods of uncertainty is why Trupanion exists! I can think of several other “crises” or periods of uncertainty in our 20 year history, but not one that so clearly embodies the challenges of an unexpected health crisis.

Planning for the unexpected is the heart of the problem Trupanion was designed to solve. How do pet owners budget for veterinary expenses if and when their pet becomes sick or injured?

So, how do we know if we are progressing or doing well? The basic answer, like our mission, is simple: the more pet owners and pets that we are helping, the better we are doing. In addition, we have key metrics, which when monitored on annual intervals, provide insight into the overall strength and health of our business.

We have **three key financial goals**. We don't expect we will achieve them each and every year, but you can be assured that we will try our best. These three primary annual goals are:

Grow total revenue between 20% and 30% annually.

Compound the cash from existing and new pets. The keys to compounding cash flow are growth in pets, average revenue per pet, and our **adjusted operating margin** per pet. For our monthly subscription pets, we target an adjusted operating margin of 15%.

Re-invest our discretionary cash at internal rates of return between 30% and 40%. At these internal rates of return, we aim to invest as much discretionary cash as possible, while remaining **free cash flow** positive.

Adjusted Operating Margin (AOM):

The amount of Adjusted Operating Income (defined below) as a percentage of revenue generated from our members during the period.

Discretionary Cash: This is a term that we use to describe our cash flow that could be returned to shareholders in the way of dividends, or reinvested to grow the company.

Internal Rate of Return (IRR): A calculation used to evaluate the return on an investment over time.

Free Cash Flow: Cash we generated from operations, net of any cash used on capital expenditures such as purchases of property or equipment and reinvested to grow the business.

I am pleased to report that based on these three financial goals, 2019 was a good year. Compared to the prior year, revenue grew **26%** and the cash we generated from our existing pets, before investment in new pet acquisition (which we refer to as our **adjusted operating income**), grew 39% to **\$44.2 million**. We were able to invest **\$32.9 million** of this discretionary income to acquire 141,283 new **subscription pets**, where we calculate we will earn a **40%** internal rate of return for the average pet.

Key Metrics

As in previous years, here are our key metrics. My intention is to share the same (or similar) key metrics with you every year.

Table 1. Key Metrics

	2014	2015	2016	2017	2018	2019
Revenue	\$115.9M	\$147.0M	\$188.2M	\$242.7M	\$304.0M	\$383.9M
YoY revenue growth	38%	27%	28%	29%	25%	26%
Adjusted operating income (AOI)	\$0.9M	\$3.6M	\$14.8M	\$23.4M	\$31.9M	\$44.2M
Adjusted Operating Margin (AOM)	1%	2%	8%	10%	10%	12%
Pet acquisition cost	\$11.1M	\$14.8M	\$14.7M	\$18.4M	\$23.7M	\$33.3M ¹
Internal rate of return (from new subscription pets)	N/A	N/A	31%	35%	37%	40% ²
Free cash flow	(\$16.4M)	(\$15.3M)	\$3.1M	\$6.5M	\$8.3M ³	\$10.8M

¹The \$33.3M acquisition spend noted in this table includes spend in our other business segment, **\$32.9M** of which was spent acquiring subscription pets in 2019.

²In 2019, we began to use the per pet unit economics specific to our subscription business as an input for our internal rate of return calculation. Prior to 2019, per pet unit economics reflected our consolidated business.

³2018 free cash flow of \$8.3 million reflects free cash flow of (\$44.3) million, adjusted to exclude the \$52.5 million used to purchase our building.

Adjusted Operating Income (AOI): The profit we generate from our members during a period, adjusted to remove acquisition costs and certain non-cash items.

Subscription Pets: Pets that are enrolled with Trupanion, generally where the member pays Trupanion directly every month as opposed to our **other business** segment.

Other Business: In addition to our direct to consumer subscription business, we have a business to business component. It comprises several initiatives with one unifying characteristic: the pet owner does not pay us directly; a third-party pays us. While lower margin, our other business adds to our data advantage, provides us insights into alternative products and channels and allows us to share in the success of the broader category. We also spend very little to acquire pets within this segment.

Pet Acquisition Spend: Our total sales and marketing expense for our subscription business, minus our **sign-up fee**. This also excludes stock-based compensation for our sales and marketing team members. When divided by the total number of subscription pets enrolled in a given period, we refer to this as our Pet Acquisition Cost (PAC). This is a one-time expense.

Sign-Up Fees: A fee that we charge new members when they enroll to cover up-front costs.

Table 2. Financial Metrics/Performance 2012-2019

Year	Enrolled pets	Revenue	YoY revenue growth	Adjusted operating income	Invested capital to acquire new pets	IRR on an average pet	Cash, short-term investments, our building assets, minus debt	Earnings (Net Loss)
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	\$188.2M	28%	\$14.8M	\$14.7M	31%	\$48.8M	(\$6.9M)
2017	423,194	\$242.7M	29%	\$23.4M	\$18.4M	35%	\$54.4M	(\$1.5M)
2018	521,326	\$304.0M	25%	\$31.9M	\$23.7M	37%	\$134.7M	(\$0.9M)
2019	646,728	\$383.9M	26%	\$44.2M	\$33.3M	40%	\$139.4M	(\$1.8M)

Per-Share Performance

We closely track stock-based compensation and **dilution**. At the end of 2019, our fully diluted share count, including options and unvested restricted stock units, was **37,951,839**. In 2019, we calculated an increase in Trupanion's intrinsic value per share for compensation purposes (based on a two-year compounded annual growth rate) of 24.1% before stock grants. In accordance with our Intrinsic Value Incentive Plan, a portion of this intrinsic value growth is shared with our team members, with the remainder benefiting shareholders. Given our 24.1% intrinsic value per share growth in 2019, we shared 1.6% of this increase in value with the team, with the remaining 22.5% increase per share benefiting shareholders. Please see a full description of our Intrinsic Value Incentive Plan in the Compensation Discussion and Analysis section of our 2020 Proxy Statement. In order to share 1.6% with the team, the total size of the grant pool in 2019 was 479,039 shares. 154,138 were allocated during the year for new hire grants, individual performance awards and board compensation, leaving 324,901 shares that were issued in 2020 for our Performance Grant Program related to the 2019 fiscal year.

Our key financial metrics on a per share basis:

Table 3. Key Financial Metrics Per Share

Year	Total share count plus options, awards and warrants granted ¹	Revenue per share	YoY growth	Adjusted operating income per share	YoY growth	Cash, short-term investments, our building assets, minus debt per share	YoY growth	Earnings (loss) per share ²
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)
2017	35,444,460	\$6.85	27%	\$0.66	57%	\$1.53	9%	\$(0.05)
2018	37,862,666	\$8.03	17%	\$0.85	28%	\$3.56	133%	\$(0.03)
2019	37,951,839	\$10.12	26%	\$1.16	37%	\$3.67	3%	\$(0.05)

¹Share count includes outstanding shares plus unexercised options and unvested restricted stock, as well as shares granted in subsequent year pertaining to the year's performance.

²Loss per share is calculated using the GAAP basic weighted-average shares at year end.

A quick note on the difference between **GAAP** earnings and cash flow. Unlike earnings, which is subject to GAAP accounting, cash flow represents the actual cash flowing into the company. Accounting standards, like the treatment of **deferred revenue** and **depreciation**, impact earnings, but are excluded from cash flow. We manage the business on a cash flow basis. The guardrails we have put in place regarding deployment of our capital are to do so at high internal rates of return (between 30 and 40%), while maintaining positive free cash flow.

Stock Dilution: The decrease in existing shareholders' ownership percentage of a company as a result of the company issuing new equity.

Generally Accepted Accounting Principles (GAAP):

The accounting standards established by the Financial Accounting Standards Board and adopted by the U.S. Securities and Exchange Commission (SEC).

Deferred Revenue: At Trupanion, we collect an entire month of premium on the first day that a member enrolls. This also becomes their monthly billing date. For members that do not enroll on the first day of the month, a portion of what they paid for their subscription that applies to coverage in the following month must be noted as "deferred revenue." As an example, if a member enrolls on January 25th, they would pay for coverage between January 25th and February 24th. We would consider 6 days of their monthly cost in January as "revenue," and the remaining 24 days would be considered "deferred revenue" in January. In February, those 24 days previously treated to as "deferred revenue" in January would be "revenue" in February.

Depreciation: When we purchase an asset whose value degrades over time (which is any physical asset that is not land), rather than noting the purchase of this asset as an expense at the time of purchase, we will instead spread out the cost of that expense over the life of the asset in accordance with GAAP. For example, if we purchase a \$2,000 laptop for a team member, and that laptop is expected to last for four years before needing to be replaced, every month from the date of purchase we would reduce the value of the laptop by \$41.66 in our books.

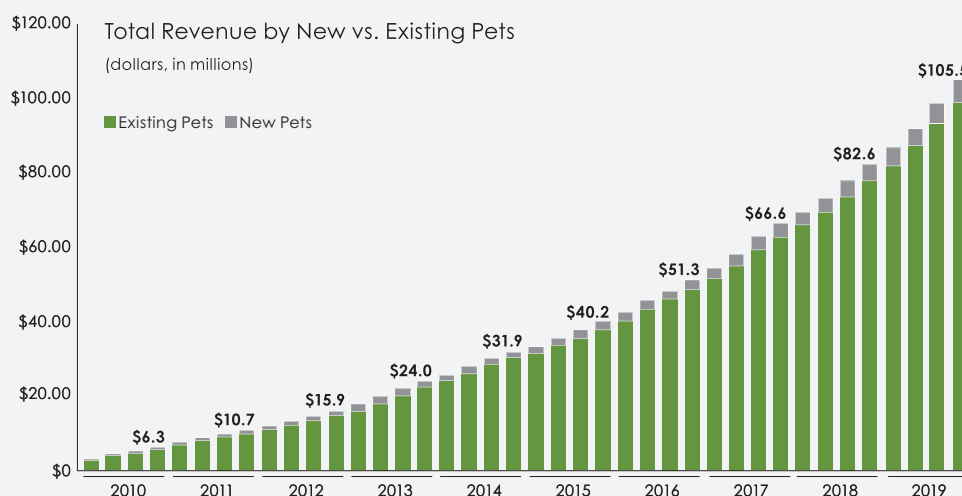
Today, as we enter our third decade, most of Trupanion Inc.'s business and **intrinsic value** are derived from our direct-to-consumer monthly subscription business, which has two key attributes: high **retention** rates and a large underpenetrated market.

Below is a break-down between our two segments of business:

Intrinsic Value: Our calculation of how much our business is worth, irrespective of the determination of the public markets.

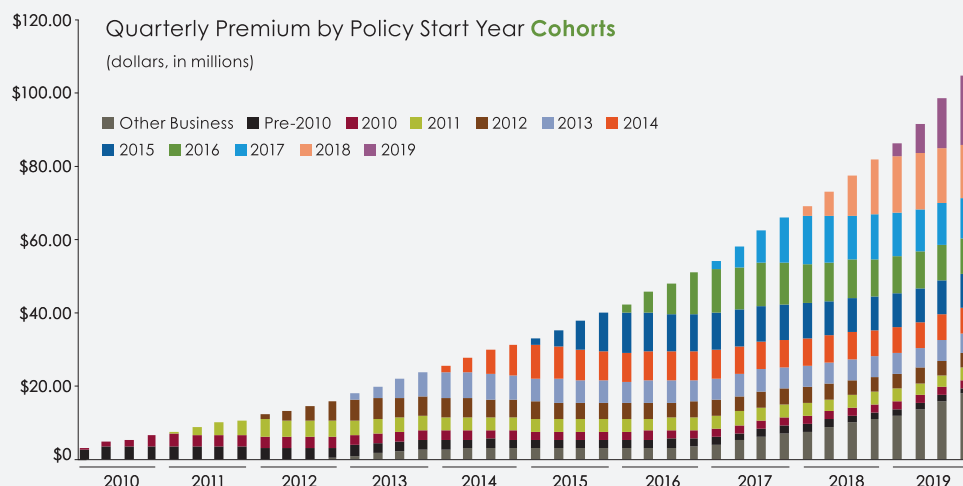
Table 4. Business Segments

	Subscription Business	Other Business	Total Business	Subscription Business	Other Business	Total Business
Revenue	100%	100%	100%	\$321.2M	\$62.8M	\$383.9M
Less: Paying Veterinary Invoices	72%	61%	70%	\$231.7M	\$38.5M	\$270.3M
Less: Variable Expenses	9%	29%	12%	\$29.4M	\$18.3M	\$47.7M
Less: Fixed Expenses	6%	6%	6%	\$18.2M	\$3.6M	\$21.7M
Equals Adjusted Operating Margin (AOM) or Income (AOI)	13%	4%	12%	\$41.9M	\$2.3M	\$44.2M



Retention: Subscription pets that remained enrolled each month, on average, monitored over a rolling 12 month period.

Cohort: A cohort is a group of pets who share a defining characteristic. In this case, we refer to cohorts as a group of pets enrolling in the same quarter.



My Report Card on the Year

Same Store Sales **B**

This was an area of good progress and learning in 2019. **Same store sales** measures the **penetration rate** of Trupanion insured pets among our existing **active hospital** base. We endeavor to grow our active hospital count, while simultaneously increasing the rate at which pets are enrolling with Trupanion at veterinary hospitals. Doing so is really, really hard!

The rate at which we add active hospitals can influence growth in same store sales. Hospitals further down the adoption curve naturally carry a lower penetration rate of Trupanion insured pets. In 2019, we were able to deliver 11% growth in active hospitals, while increasing the number of pets that enrolled per active hospital per month to 1.14 from 1.13 in 2018.

Growth in same store sales was driven by increased leads, benefiting from the number of hospitals that have installed **our software** and have an assigned inside **Account Manager** to act as a hospital's point of contact in between **Territory Partner** visits. We ended the year with over 4,850 hospitals with our software, and about three dozen inside Account Managers. For those hospitals that have had our software and an assigned inside Account Manager for at least six months, we're seeing a consistent 48% increase in the number of pets enrolled per hospital, per month.

Conversion Rates **C**

Our primary challenge in increasing **conversion rates** lies in more effectively communicating our value proposition to prospective members. Our efforts to do so during 2019 did not move the needle, despite a significant investment year over year.

Q3 was a good quarter, where certain tests and initiatives worked well. In Q4, our tests did not work well. We have plenty of reasons to be optimistic; as I write this letter, we have seen some encouraging improvements to this metric. Execution, however, is not always up and to the right. We will have to put 2019 down as a year of learning.

Attached and linked to this year's letter is a member facing document titled: "Why Trupanion." This document provides some of the key content that we need to learn how to share more effectively with pet owners who are trying to decide if they should choose Trupanion. We are already exceptionally skilled at delivering this content over the phone. The team needs to become more proficient at delivering this content via multiple formats and delivery mechanisms. This information needs to then be reinforced for new members to help increase retention during the first year. Not all new members will take the time to digest this information, but I'm confident that those who do will not only be more likely to convert, they are also more likely to become brand ambassadors.

Same Store Sales: The average number of pets enrolled per active hospital per month.

Penetration Rate: In this context, our penetration rate is the number of Trupanion-insured clients that a particular hospital cares for as a percentage of their total number of clients.

Active Hospitals: A veterinary hospital that has one or more net pets enrolled every three months.

Account Managers: Team members who support veterinary hospitals in between visits from our Territory Partners.

Territory Partner: Entrepreneurial team members who are responsible for educating the veterinarians in their exclusive geography about the benefits of pet owners having high-quality medical insurance for pets. Once they have established a relationship with these veterinarians, Territory Partners will work with veterinary staff to ensure that Trupanion members have a great customer experience when their pet gets sick or injured, which increases our retention rates. Note that the majority of a Territory Partner's compensation is tied to keeping pets enrolled, not enrolling them in the first place, which we consider to be a variable expense.

Our Software: Our software communicates with the Practice Management Software inside a hospital, which allows us to pay hospitals directly at time of invoice and eliminates a major barrier to care—the **reimbursement model** (see page 07 for definition).

Conversion Rates: The percentage of pet owners who enroll with Trupanion after receiving a quote.

Nirvana B

Getting closer to achieving **Nirvana** was a major focus in 2019. There were a few areas to celebrate—ask for details at the Shareholder Meeting! We made progress in some categories (and territories), and overall, this metric improved slightly from 2018. We define Nirvana as the referrals from members adding pets or referring friends offsetting **churn** in the business. In 2019, our monthly average of pet owners adding pets or referring friends represented 0.74% of our overall book. Churn for the year averaged 1.42% per month. The difference between the two was 0.68%, whereas in 2018 the difference was 0.72%. This is a 0.04% improvement over 2018!

Nirvana: The referrals from members adding pets or referring friends, offsetting churn in the business.

Churn: Members who are canceling their subscription.

Automating claims A-

We made lots of progress here in 2019. We increased the percentage of automated claims through our software from 4.7% in 2018 to 32.2% in 2019—with an average processing time of less than 15 seconds. Like conversion rates, automating claims provides benefits across the organization. I am pushing the team to get above 50% in 2020!

Adjusted Operating Income/Margin B

Adjusted Operating Income grew 39% year over year which, on its own, was fantastic, and in my opinion, deserves a grade of “A+”. But we must also consider our results as a percent of revenue.

As a percent of revenue, performance was mixed. Adjusted operating margin, including our other business, which runs at a lower margin, was 12% for the year. Within our direct to consumer monthly subscription business, we target a 15% adjusted operating margin.

In 2019, our adjusted operating margin for our subscription business was 13%, comprised of 72% paying veterinary invoices, 9.1% **variable expenses** and 5.7% **fixed expenses**. For the second consecutive year, we were able to scale variable expenses below our historical 10%. We're now able to target 9% moving forward—this is great for the pet owner, and great for us!

Variable Expenses: Expenses that vary alongside the number of pets that are enrolled. For example, the more members we have, the more customer service agents we need to be able to take care of those members.

Our fixed expenses were 5.7% in the year and 5.2% in the back half of the year. We are pleased to announce that we are approaching operating scale, which we define as keeping fixed expenses at 5% of revenue. This should happen when we reach the low end of our targeted range of 650,000 to 750,000 total enrolled pets. Even so, results could have been better considering that we benefited from a 1% savings after diluting the company to buy our building.

Fixed Expenses: Operating costs that do not increase in direct proportion with the number of pets we have enrolled.

Nevertheless, our run-rate as of year end implies combined variable and fixed expenses of 14%, leaving 71% available to pay veterinary invoices while meeting our 15% adjusted operating margin target. Let me be clear, our ability to hit 71% today is no greater than our ability to hit 70% last year—they both require a great deal of execution. Consistently, over the past few years, we have operated about 2% above our target payout ratio—not below. A 2% miss is okay but something to improve upon.

We have **three items** that make it difficult for our teams to hit our target of using 71% of our revenue to pay veterinary invoices for the average pet owner. They have been at play for the last couple of years and will continue to be a challenge for the next few years. They include:

Installing more of our software, which facilitates our ability to pay veterinarians directly and helps increase same store sales. When we install our software, the number of invoices we receive per 1,000 pets increases, not because there are more “**unlucky**” **pets**, but because in a **reimbursement model**, some small invoices never get submitted. Because our software is deployed at the hospital level, we cannot effectively price in advance of this deployment and it takes us about 18 months to fully roll through the one-time step up in veterinary invoice expense incurred at these hospitals. It's worth repeating that this is 100% the right thing to do for pet owners and veterinarians and we would take this trade-off every time. As we look to accelerate the number of hospitals with our software over the next several years, we expect this headwind to persist.

Increasing the percentage of invoices that are processed and paid within seconds via automation. 100% of the invoices submitted to us via our software are routed through our artificial intelligence automation tool. Some are processed via automation, and others are passed on to our claims team, which operates 24/7/365. As we try to increase the percentage of claims that are processed through our automation tool, we expect there will be mistakes as we place greater confidence in this machine to make the right decisions.

Continually improving the accuracy of our pricing categories in a more granular way. Said simply, we have some **sub-categories** that are priced at 65% and others at 75%. It would be easier to hit our target if we allowed those at 65% to stay low while we increase pricing for those at 75%, but that is not the right thing to do, and is not consistent with our pricing promise (you can learn more about our pricing promise in the attached “Why Trupanion” booklet). We lower the monthly cost for members in the sub-category priced at a 65% payout, while raising the monthly cost for members in the sub-category priced at a 75% payout, in order to achieve our overall target of paying out 71% of our revenue towards veterinary invoices in each pricing category, instead of allowing one group to subsidize another.

For me, the three tactics described above—**direct pay, automation and pricing**—are strategically important moats for our business. When stack-ranking them against hitting our near-term pricing/margin targets, they win. That being said, we strive to both build competitive moats and hit our margin targets at the same time.

In the words of one of my favorite business guru's, Dr. Edward Deming,

“ Good companies keep improving, and the most important knowledge that they embody is how to detect and eliminate errors.

Unlucky Pets: Pets that have more accidents and illnesses than the average pet. A lucky pet, by contrast, has fewer accidents and illnesses than the average pet.

Reimbursement Model: An insurance model that requires the pet owner to first pay the veterinarian for his/her services in full. The pet owner then sends the invoice to their insurance company and waits for reimbursement, which typically takes 3-5 weeks. When a hospital uses our software, the hospital receives direct payment from Trupanion at the time of checkout, which removes a substantial barrier to care in cases where the member could not afford to pay for the services rendered and wait for reimbursement.

Pricing Categories: Groups of pets who share similar features, and should therefore pay similar monthly premiums. Examples of pricing categories might be breed, geography, or age at enrollment.

Sub-categories: Pricing categories that get further refined over time as we learn more about pets through our data. For example, while a pricing category might be “geography,” sub-categories might be “state or province,” “zip code,” or “neighborhood.”

Culture & Team B+

2019 was a mixed year for me on this front. Our culture at Trupanion is unique. We don't embrace status or typical hierarchy. Trust is a minimum requirement. During the year we hit a few bumps, made a few course corrections and ended the year back on track. Our people, culture and communications need to constantly evolve and improve—at times, we could have moved faster. My role is to lead by example; at times I have struggled to evolve.

During the year, I listened to a podcast interview of Shopify CEO Tobias Lütke, where he explained:

“*In a company that's growing, significantly, 50% a year or something like this...that means that everyone has to get 50% better at their job just to stand still. If you want to grow and make it further, you have to outpace the growth of the company and that's tough. It's tough to do. You have to be really committed.*”

When it comes to our team, there are three critical areas of focus: bringing in amazing team members, offering best-in-class learning and development opportunities, and providing an environment that best encourages team members' fulfillment. In 2019, our team was able to accelerate the time it took to find and onboard key positions. We were impressed by these results in a year when most companies were having difficulty adding to their teams. I am especially proud that for certain key positions where we undertook nationwide searches and identified very skilled people, our side-by-side comparisons confirmed that our internally developed candidates were still the best people for the jobs.

In fact, 123 team members advanced their careers last year and our overall team member retention rate increased by more than 3%. This makes me smile 😊. I believe that the ability to attract and retain amazing people is an underappreciated strength. At the end of the day, our culture and mission are paying dividends.

Our mission is strong, and our addressable market is large. Our core business model is compelling; our moats are deep. Metrics inform us of our progress and our underlying health. Strong execution, leadership and culture are difficult to achieve yet rewarding.

Annual Shareholder Meeting

We intend to discuss these initiatives, and more, during our upcoming **Annual Shareholder Meeting on June 11th**. It had been our hope to host you all again at our headquarters in Seattle, but because we are prioritizing the health and safety of our team members and community, we will be moving to an online format this year.

How We Make Strategic Decisions

When we are making strategic decisions, or choosing how to deploy our discretionary cash, we use a 15-year discounted cash flow (DCF) model to determine the value we expect to create.

This 15-year discounted cash flow (DCF) model informs what we believe is the intrinsic value of our company and how it changes over time. These changes, when positive, result in value creation. Building and using our DCF model not only keeps us honest about our value creation per share, but it also reinforces the importance of our key metrics and informs our decision making.

Said another way, our model is a tool to help track our progress as well as chart our future. Our model does not determine our destination, nor does it reflect our aspirations. Our aspirations are to outperform our model! Rather, it acts as a compass, helping us navigate and plot our course.

Our metrics, how they have trended historically, and our conviction around how they will trend in the future, are the building blocks of our intrinsic value model. For me, using the past as a guide is the single best method for trying to predict the future. If the past was consistent and predictable, then one can reasonably expect it to be a useful forecasting tool.

We believe all companies should be valued on future cash flows. To accomplish this task, one needs to build a DCF model. When an informed investor builds such a model for Trupanion, we believe they will better understand how and why our business is differentiated. Absent this exercise, one is only speculating as to how best to value a company.

There is no such thing as the perfect DCF model, but I am confident that when it comes to our business, our interpretation is well thought out and defensible. Our goal is to be transparent to our shareholders, employees (who are also shareholders!), Territory Partners, veterinarians, and members. We share what we believe are our key metrics and how they impact our intrinsic value. With that explanation as a backdrop, let me tell you how we build it and why.

How we build our 15-year DCF model:

After years of monitoring what we believe is our intrinsic value and building our DCF model using our key metrics, we have learned a lot. We expect our knowledge to continue to grow and our methodology, key metrics and models to continue to evolve and improve. Over the last few years, our inputs are more rule-based, and although they have shown a slightly more conservative view of our estimated intrinsic value, we believe they are more defensible. Every year we replace our model's forecast for the current year with actual results, and then project cash flows for the remaining 14 years, including the terminal period in year 15. At the end of each year, we measure the year over year change in intrinsic value, compared to the prior model, indicating how much per share value we created.

To demonstrate how our model works, we are going to turn the clocks back to January 1st, 2019 and show you what our 2018 model forecasted for 2019. This practice informs us of what we would have expected our intrinsic value per share to be at the end of 2019. We'll also compare our projected 2019 results to our actual performance, allowing the reader the ability to measure the accuracy of the assumptions used to project future periods.

At the end of this exercise, we will have provided you with the roadmap of how we internally update our model each year.

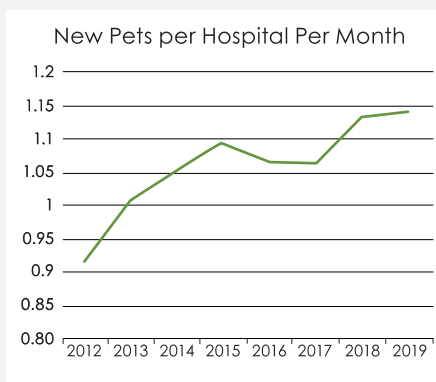
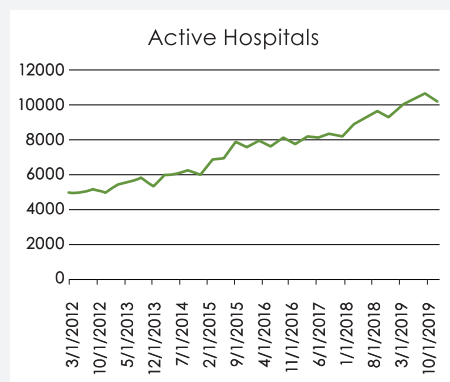
I'll reiterate that the following analysis is simply a projection applying a set of rules that relate to assumptions about our business based on historical performance. As our analysis will show, our actual results will be different than what is predicted by the model. Therefore, **any numbers represented herein should not be interpreted as guidance**, nor do they represent our strategic goals.

I'll also note that we aspire to outperform our model through both great execution and a bit of luck, but we are mindful that we may underperform if we take our eye off the ball. Many of our strategic investments—today and in the future—are aimed at driving improved results across our key metrics. This model, driven by key metrics, informs us of the past and tells us what we need to do in the future—sometimes years in advance (more on that in a moment!).

We have several facets of our current business. Our direct to consumer monthly subscription business is the largest component and where the most value is created. I will start with this facet of the business first; we will then add other business, and when summed together, this will provide a valuation for the entire organization.

How many new pet enrollments should we include in future years when building our model?

We focus on the number of veterinary hospitals recommending Trupanion (active hospitals), the average number of new pets per hospital per month that enroll in our subscription product (same store sales), and their underlying trend lines. See below:



As I stated before, we believe the best predictor of future performance is past performance. For future new enrollments, we look at the growth rate in our number of active hospitals and the change in the number of enrollments per hospital per month. Going back to 2014, and using 3-year averages for both metrics, our predictive accuracy using this methodology has been **98.2%**.

Table 5. Predictive Accuracy Of New Pet Assumptions

Year	Number of Territory Partners	Estimated number of clinics we are visiting every 60-90 days	Estimated aggregate number of face-to-face visits	Actual average number of active hospitals	YOY percentage change	Actual average number of new pets per Hospital per month	YOY change	Predicted new pets	Actual number of new pets	Predictive accuracy
2012	34	15,000	262,000	5,034	5%	0.918	0.100	-	-	-
2013	40	16,200	324,000	5,531	10%	1.008	0.090	-	-	-
2014	58	15,400	404,000	6,098	10%	1.053	0.045	82,969	77,066	93%
2015	84	19,000	490,000	7,359	21%	1.093	0.040	89,704	96,556	108%
2016	105	21,300	577,000	7,875	7%	1.066	-0.028	115,568	100,692	87%
2017	107	19,800	662,000	8,242	5%	1.063	-0.002	115,465	105,180	91%
2018	123	20,200	751,000	9,279	13%	1.133	0.070	116,899	126,182	108%
2019	130	21,600	852,000	10,315	11%	1.141	0.008	137,981	141,283	102%
										98.2%

STEP 1

When building the 15-year discounted cash flow model, we **first calculate how many pets we're adding in the first year.**

Table 5 shows that we averaged **9,279** active hospitals with average same store sales of **1.133** pets per month in 2018. Our 3-year trend line for adding active hospitals in 2018 predicts an **8.1%** growth rate per year. Our same store sales 3-year trend line shows a growth rate of an additional **0.013** pets per month or a **1.2%** increase in same store sales for 2019. Based on these assumptions, we can project **137,981** gross new subscription pets in 2019.

Step 1:

$$\begin{array}{r} 7\% \text{ avg. growth rate '16} \\ 5\% \text{ avg. growth rate '17} \\ + 13\% \text{ avg. growth rate '18} \\ \hline 25 \\ \div 3 \text{ years} \\ \hline 8.1\% \text{ predicted avg. growth rate '19} \end{array}$$

Step 2:

$$\begin{array}{r} 9,279 \text{ active hospitals '18} \\ \times 8.1\% \text{ predicted avg. growth rate '19} \\ \hline 751 \text{ predicted new active hospitals '19} \\ \\ 9,279 \text{ active hospitals '18} \\ + 751 \text{ predicted new active hospitals '19} \\ \hline 10,029 \text{ total active hospitals '19} \end{array}$$

Step 3:

$$\begin{array}{r} -0.028 \text{ YoY change of pets in enrolled '16} \\ - 0.002 \text{ YoY change of pets in enrolled '17} \\ + 0.070 \text{ YoY change of pets in enrolled '18} \\ \hline 0.040 \\ \div 3 \text{ years} \\ \hline 0.013 \text{ avg. YoY change '16-'18} \\ +1.133 \text{ avg. new pets per hospital per month '18} \\ \hline 1.146 \text{ predicted same store sales '19} \end{array}$$

Step 4:

$$\begin{array}{r} 10,029 \text{ predicted total active hospitals '19} \\ \times 1.146 \text{ predicted same store sales '19} \\ \hline 11,498 \text{ predicted new pets per month '19} \\ \\ 11,498 \text{ predicted new pets per month '19} \\ \times 12 \text{ months} \\ \hline 137,981 \text{ predicted new subscription pets '19} \end{array}$$

Compare this to our actual gross new pets in 2019 of **141,283**, which exceeded our predicted gross new pets by 2%. In our 2019 model, this additional growth would be incorporated into future assumptions, as the metrics for predicting new pets is based on the most recent 3-year trend.

Before we move on to retention, I want to point out how we look to the model to help inform strategy. Recall the 8.1% predictive growth rate in active hospitals noted above. Assuming we grow our veterinary hospital base by 8.1% for 15 consecutive years, we're left with approximately 30,000 active hospitals in 2033. That's quite a feat considering there are only 25,000 veterinary hospitals in North America today. Indeed, the model demonstrates that in order to achieve this level of success,

expansion beyond North America will be necessary. In this example, forecasted growth in active hospitals illustrates how our model can help inform our decision making years in advance.

Next, we will turn to retention. As introduced in our shareholder letter last year, I believe the following is the most helpful view of retention for the purposes of steps 2 and 3.

Table 6. 2018 Churn By Rate Change

2018 Churn	Active Pets at Year End	Number of Cancelled Pets	Percentage of Pets in 2018	Monthly Churn	Monthly Retention
No Rate Change (New Pets)	86,914	26,960	20.18%	2.79%	97.21%
Rate Change < 20%	290,719	30,000	67.49%	0.93%	99.07%
Rate Change > 20%	53,137	10,135	12.34%	1.69%	98.31%
Total	430,770	67,095	100.00%	1.40%	98.60%

We just started reviewing churn by the above member groupings in 2018. As mentioned, this model progresses as we continue to develop and refine assumptions with time. In the future, with more historical data, we may use a blended rate or another approach if those methodologies prove more accurate for capturing retention rates.

To project cancellations we consider that retention in the first year is different than retention after the first year a member enrolls. For this reason, cancellations are projected by using our historical experience for first year retention (and applying that rate to new pets added during the year). Reducing the number of pets that cancel within the first year, and before they ever receive a rate change, remains our biggest opportunity. After the first year, historical experience for retention is applied to our existing book of business each year. This better reflects the expected overall retention rate based on the number of new enrollments.

STEP 2

Calculate how many of the pets enrolling in the first year will also cancel in that first year.

Use the "Monthly Churn" for "Pets with No Rate Change" of **2.79%** from Table 6 to calculate.

Table 7. Net New Subscription Pets, Year 1 Churn

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	2019
Remaining subscription pets from prior month		11,177	22,042	32,604	42,871	52,852	62,554	71,986	81,155	90,068	98,732	107,154	
New subscription pets	11,498	11,498	11,498	11,498	11,498	11,498	11,498	11,498	11,498	11,498	11,498	11,498	
Monthly churn For new pets added in year 1 at 2.79%	(321)	(321)	(321)	(321)	(321)	(321)	(321)	(321)	(321)	(321)	(321)	(321)	
Monthly churn for remaining subscription pets at 2.79%	-	(312)	(615)	(910)	(1,196)	(1,475)	(1,745)	(2,008)	(2,264)	(2,513)	(2,755)	(2,990)	
Total 2019 cohort of new pets	11,177	22,042	32,604	42,871	52,852	62,554	71,986	81,155	90,068	98,732	107,154	115,341	115,341

The above shows 2019 gross pet adds averaged throughout the year. In reality, new pets added build throughout the year and vary based on seasonality and the number of days in a month. The variable enrollment growth within a year adds complexity without any meaningful change to the ultimate calculation.

Step 1: **11,498** new subscription pets in Jan '19
 x **2.79%** monthly churn with no rate change in '18 (see Table 6)
321 predicted cancellations in Jan '19

11,498 new subscription pets in Jan '19
 - 321 predicted cancellations in Jan '19
11,177 remaining pets enrolled from this cohort at the end of Jan '19

Step 2: 11,177 remaining pets enrolled from this cohort at the end of Jan '19
 x **2.79%** monthly churn with no rate change ('18)
312 predicted cancellations in Feb '19 for new subscription pets in Jan '19

11,177 remaining pets enrolled from this cohort at the end of Jan '19
 - 312 predicted cancellations in Feb '19 for new subscription pets in Jan '19
 - 321 predicted cancellations in Feb '19 for new subscription pets in Feb '19
 + 11,498 new subscription pets in Jan '19
22,042 remaining pets enrolled from this cohort at the end of Feb '19

Step 3: Repeat Step 2 for every month through December to calculate the total retained pets who enrolled in the first year: **115,341**.

STEP 3

Project monthly cancellations of the pets who have been enrolled longer than a year.

Our blended average between the **67.49%** of pet owners who received a rate increase that was less than 20% in 2018 (see Table 6) with a **0.93%** monthly churn rate and the **12.34%** of pet owners who received a rate change of greater than 20% in 2018 with a monthly churn of **1.69%**, is a **1.05%** monthly churn for existing pets.

Table 8. Monthly Retention of Existing Pets

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	2019
Pets who have been enrolled longer than a year	430,770	426,247	421,771	417,342	412,960	408,624	404,333	400,088	395,887	391,730	387,617	383,547	
Monthly churn of 1.05%	(4,523)	(4,476)	(4,429)	(4,382)	(4,336)	(4,291)	(4,245)	(4,201)	(4,157)	(4,113)	(4,070)	(4,027)	
Remaining pets who have been enrolled longer than a year	426,247	421,771	417,342	412,960	408,624	404,333	400,088	395,887	391,730	387,617	383,547	379,520	379,520

Step 1: **430,770** subscription enrolled pets as of December 31, 2018
 x **1.05%** monthly churn
4,523 Jan churn
 430,770 subscription enrolled pets as of December 31, 2018
 - 4,523 Jan churn
426,247 remaining pets who have been enrolled longer than a year at the end of Jan '19

Step 2: **426,247** remaining pets who have been enrolled longer than a year at the end of Jan '19
 x **1.05%** monthly churn
4,476 Feb churn
 426,247 remaining pets who have been enrolled longer than a year at the end of Jan '19
 - 4,476 Feb churn
421,771 remaining pets who have been enrolled longer than a year at the end of Feb '19

Step 3: Repeat Step 2 for every month through December to calculate remaining pets who have been enrolled longer than a year at the end of 2019: **379,520**.

STEP 4

Predict total number of pets enrolled in each month of the first year. Sum each month of total retained pets through the year to calculate total **pet months** for the year.

Compare this to actual pet months of 5,575,676 in 2019—slightly below our prediction, due to a slight decline in our actual retention rates in 2019, shown below:

Pet Months: The sum of adding together the ending enrolled pets each month over a period of time.

Table 9. Subscription Pet Months

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov	Dec	2019
Total 2019 cohort retained new pets	11,177	22,042	32,604	42,871	52,852	62,554	71,986	81,155	90,068	98,732	107,154	115,341	
Total retained existing pets	426,247	421,771	417,342	412,960	408,624	404,333	400,088	395,887	391,730	387,617	383,547	379,520	
Total retained pets	437,424	443,813	449,946	455,831	461,476	466,887	472,074	477,042	481,798	486,349	490,701	494,861	5,618,202 Pet Months

Note that the sum of the bottom row of Table 9 is **5,618,202**, which is what we call pet months. The above calculation is a simplified illustrative example compared to our actual model, and when we factor in the impact of new pets added in 2018 that have higher cancellations for a portion of 2019; the total pet months projected for 2019 was 5,602,431 in our model. This is the number of subscription “pet months” we would use to project 2019 in our DCF model. Pet months is a metric that we commonly use within the company and it will come up later in the model analysis.

437,424 Jan
443,813 Feb
449,946 Mar
455,831 Apr
461,476 May
466,887 Jun
472,074 Jul
477,042 Aug
481,798 Sept
486,349 Oct
490,701 Nov
+ 494,861 Dec
5,618,202 pet months '19

Compare this to actual pet months of 5,575,670 in 2019—slightly below our prediction, due to a slight decline in our actual retention rates in 2019, shown below:

Table 10. 2019 Churn By Rate Change

2019 Churn	Active pets at year end	Number of canceled pets	Distribution	Monthly Churn	Monthly Retention
No Rate Change	100,008	30,155	20.24%	2.70%	97.30%
Rate Change < 20%	306,681	34,138	62.08%	1.00%	99.00%
Rate Change > 20%	87,337	13,734	17.68%	1.41%	98.59%
Total	494,026	78,027	100.00%	1.42%	98.58%

STEP 5

Isolate the cash earned from a single average subscription pet per month.

Below is our monthly per-pet economics, or cash flow prior to new pet acquisition, for our average subscription pet in 2018:

Table 11. 2018 Per Pet Monthly Economics

	2018	
Average monthly cost (ARPU)	\$54.34	100.0%
– Paying veterinary invoices (COGS)	(\$39.33)	72.4%
– Variable expense (fast, 24/7 service)	(\$5.08)	9.3%
= Contribution profit	\$9.93	18.3%
– Fixed expenses (G&A + IT)	(\$3.65)	6.7%
= Profit per pet per month	\$6.28	11.6%
– a 1% capital charge	(\$0.54)	1.0%
= the cash generated per month for the average pet	\$5.74	10.6%

Monthly Cost: The amount an average pet owner pays per month for a Trupanion subscription.

Average Revenue Per Unit (ARPU): A term commonly used in monthly subscription business models. In our case, we track and report the average revenue of each pet per month.

Cost of Goods Sold (COGS): For us, these are expenses related to paying veterinary invoices.

General and Administrative Costs (G&A): These expenses support our business operations in a way that's not directly tied to supporting our members (for example, our legal and finance teams would fall into this bucket).

Frictional Costs: All of the direct and indirect costs associated with issuing a policy to an enrolled pet.

Why we add a 1% capital charge

In 2018, we earned **\$6.28** per month for the average subscription pet. From a cash perspective \$6.28 is correct, but because we own an insurance entity with the goal of lowering **frictional costs**, we are required to hold assets in case every enrolled pet became sick or injured at the same time. Some types of insurance businesses need to hold considerable amounts of cash in surplus, for unpredictably expensive events like Hurricane Katrina. Other types of insurance businesses need to hold less surplus, like dental insurance. Regardless of the ratio, this surplus (of assets or liabilities) is required, sensible and necessary.

At Trupanion, we currently have a revenue to capital ratio of approximately 4.8:1. This means that for every pet we enroll at our average subscription cost of **\$54.34** per month, we need to have \$11.32 sitting in an insurance entity.

Over the years, we have used debt as a tool to help with our overall growth and, when required, help satisfy our capital requirements. This debt, when utilized, is cash collateralized by our cash surplus and our other assets. I view the servicing of this debt to be a variable expense to operate our business. The spread between what we are being charged on a line of credit and what we are earning on our cash surplus works out to about 1% of revenue, thus the 1% capital charge.

Back to our monthly subscription economics. In 2018, our pet owners paid us an average \$54.34 per pet. Our cost to deliver on our product, including a 1% charge for our required surplus capital, was \$48.60. This left us with **\$5.74** profit for the average pet in 2018 prior to investment in new pet acquisition.

Our average lifetime retention of a pet was 71.4 months in 2018. $71.4 \text{ months} \times \$5.74 = \$409.84$. We spent \$23 million dollars one-time enrolling approximately 126,000 new subscription pets in 2018 that, excluding sign-up fees, averages to \$164 spent per pet. Investing \$164 once to get \$409.84 in return is a 250% return on your invested capital. Because it takes 71 months to earn back that capital, the 250% return equates to an estimated 46% average return per year, which we describe as our internal rate of return (IRR).

As a reminder, in 2018 our reported internal rate of return was informed by our **blended adjusted operating income**. Had we isolated per pet unit economics specific to our subscription business, our estimated internal rate of return in 2018 would have been 46%. At a 46% IRR, there is room to be more aggressive in the deployment of our acquisition spend!

Blended Adjusted Operating

Income: The AOI for both our subscription business and our other business. Moving forward, when we use the term "AOI" (as opposed to "Blended AOI"), we are referring to the AOI of our subscription business only.

Which margin matters, and why?

When building a DCF model, the breakdown of the margin above the "cash generated" line does not matter to me because it does not impact the cash flow. See these three examples:

Table 12. Cash Flow Per Month Margin Examples

	Example 1	Example 2	Example 3
Average monthly cost (ARPU)	100%	100%	100%
– Paying veterinary invoices (COGS)	68%	71%	73%
– Variable expense (fast, 24/7 service)	11%	9%	8%
– Fixed expenses (G&A + IT)	6%	5%	4%
= Adjusted operating margin	15%	15%	15%
– Capital charge for money we are required to hold in cash or assets	1%	1%	1%
= Cash generated per month for the average pet after a capital charge	14%	14%	14%

Although these three examples would yield the same cash flow per month, they would likely have different outcomes. Example 1 would be the easiest to manage as you would have more money for operating both your variable and fixed expenses. Example 3 would be the most difficult to execute but would likely yield the best long-term value as the pet owner would be receiving the best value proposition. All else being equal, over time I would expect that Example 3 would have higher conversion rates and longer retention rates than Examples 1 or 2. Example 3 has the biggest moats and is therefore the most likely to have consistent growth over long periods of time.

For the next several years, we will be targeting **Example 2**. Our COGS target is the most difficult to hit and we can expect fluctuations of +/- 2% for a year if we are executing well.

Back to Step 5: Isolate the cash earned from a single average subscription pet per month.

We have our per pet unit economics for 2018. How do we determine what to use as an average cash flow per pet in 2019 and in future years? We increase 2018 ARPU by 5.5% to represent the projected annual increase in the cost of veterinary care. Remember, we're a **cost-plus model**, and we historically have seen the cost of veterinary care rise 5-6% each year. We anticipate this trend to continue and will revisit this metric again in our discussion of terminal year value.

We should also include an assumption of our estimated profit per pet per month after our fixed expenses and a one percent capital charge (prior to new pet acquisition expense).

We project spend for paying veterinary invoices and variable expenses using a 3-year historical average of our subscription **gross margin** to ensure that we do not assume changes in gross margin until proven to be repeatable. Following this, we project that our fixed expenses will continue to scale at approximately half the rate of revenue to 5.8% of revenue in 2019 and continued scale to our 5% target thereafter. In future years, we do not allow our fixed expenses to scale beyond our 5% target, with the exception of allowing the benefits of owning our home office building to flow through. As a reminder, our building acquisition also was done to provide surplus capital efficiencies and long-term space planning flexibility.

Based on the methodology discussed above, we would predict the following 2019 per-pet economics, compared to 2019 actuals.

Cost-Plus Model: Trupanion's pricing methodology involves first understanding the cost of paying for items covered under our policy, then adding in the cost of running our business plus a small profit, which equals the monthly cost of the insurance policy. Most insurance companies will instead target a specific monthly cost for their customers, and in doing so, they must lessen their coverage (sometimes annually) in order to meet this target monthly cost.

Gross Margin: Our profit after paying claims, as well as the cost associated with paying out claims and supporting members, expressed as a percentage of revenue. This margin does not include our fixed expenses.

Table 13. Per Pet Unit Economics–Predicated Vs Actual

	2018 Actuals		2019 Predicted		2019 Actuals	
Average monthly cost (ARPU)	\$54.34	100.0%	\$57.32	100.0%	\$57.52	100.0%
– Paying veterinary invoices (COGS)	(\$39.33)	72.4%	(\$40.99)	71.5%	(\$41.56)	72.2%
– Variable expense (fast 24/7 service)	(\$5.08)	9.3%	(\$5.45)	9.5%	(\$5.27)	9.2%
= Contribution profit	\$9.93	18.3%	\$10.88	19.0%	\$10.69	18.6%
– Fixed expenses (G&A + IT)	(\$3.65)	6.7%	(\$3.29)	5.7%	(\$3.26)	5.7%
= Profit per pet per month	\$6.28	11.6%	\$7.59	13.2%	\$7.43	12.9%
- Capital charge for money we are required to hold in cash or assets	(\$0.54)	1.0%	(\$0.57)	1.0%	(\$0.58)	1.0%
= Cash generated per month for the average pet	\$5.74	10.6%	\$7.02	12.2%	\$6.85	11.9%

Viewing our per pet economics against 2019 actuals illustrates a predicted improvement in our adjusted operating margin that wasn't fully realized by **0.3%** of margin in 2019.

Based on the expected pet growth and churn determined in previous steps, the 2018 model predicted 491,440 total subscription pets enrolled by the end of the year 2019 with **5,602,431** pet months. When multiplied by the projected **\$7.02** of cash earned for the average pet in a month in 2019, the total cash generated from the subscription pets would be **\$39.3M** for the year. This projection is compared to actuals below.

Table 14. Predictive Accuracy Of Cash Generated By The Average Subscription Pet

	Monthly cash generated from the average subscription pet	Total Pet Months	Total cash generated from subscription pets
2019 Predicted	\$7.02	5,602,431	\$39.3M
2019 Actual	\$6.85	5,575,670	\$38.2M

To determine the remaining future enrollments to add annually, we use the historical growth assumptions to project the first 5 years after the current year in the model. As a reminder, these assumptions are a combination of two drivers: (1) the 3-year average of the historical growth rate in active hospitals, and (2) the 3-year average of the historical same store sales growth in pets. Adding in our churn rates by new and existing pet cohorts provides our pet month additions through year 5 after the current year.

To avoid creating too much volatility in the outer years of the model, we then project pet months for the remaining years at a constant growth rate (until the terminal year) based on the trend in pet months.

Using this methodology to calculate our value in 2019, we updated for our 2019 actuals and projected future pet months and subscription cash generated based on the methodology discussed above, resulting in the following (prior to the terminal year).

Table 15. Discounted Cash Flow Model Inputs 1.1

	Monthly cash generated from the average subscription pet	Total pet months	Total cash generated subscription pets
2018 Actual	\$5.74	4,843,802	\$27.8M
2019 Actual	\$6.85	5,575,670	\$38.2M
2020	\$7.78	6,407,329	\$49.9M
2021	\$8.47	7,280,343	\$61.7M
2022	\$9.18	8,242,219	\$75.6M
2023	\$9.81	9,304,305	\$91.3M
2024	\$10.32	10,479,007	\$108.1M
2025	\$10.86	11,781,547	\$127.9M
2026	\$11.43	13,230,666	\$151.2M
2027	\$12.04	14,850,112	\$178.8M
2028	\$12.68	16,667,751	\$211.4M
2029	\$13.37	18,707,901	\$250.1M
2030	\$14.09	20,997,766	\$295.9M
2031	\$14.86	23,567,914	\$350.1M
2032	\$15.67	26,452,650	\$414.4M

Add the cash generated from our other business segment.

First, a quick refresher. In addition to our direct to consumer subscription business, we have a business to business component, which we refer to as our other business. Our other business segment comprises several initiatives with one unifying characteristic: the pet owner does not pay us directly, rather a business pays us. While this side of our business operates at a lower margin, our other business adds to our data advantage, provides us with insights into alternative products and channels and allows us to share in the success of the broader category. We also spend very little to acquire pets within this segment. In 2019, acquisition spend related to this segment was about \$400,000.

A sizable portion of this segment of our business today acts like a traditional insurance company. We have the capital, underwriting licenses, pricing expertise and the capacity to help other companies underwrite more business (pets).

Like most insurance companies, the third party company, or broker, is paid to bring in the business and is paid a percentage-based commission. These commissions can range between 10% and 35% depending on what the broker contributes. These contracts tend to be annual. If you get the renewal business, you would have to pay those commissions each year.

Similar to our subscription business, we are required to put up capital, and in return we earn some cash. The cash we earn becomes a return on equity. In 2019, revenue for this segment was \$62.8M and we earned profit of **\$1.7M**. We put up \$13.1M to underwrite this business at a 4.8:1 ratio. \$1.7M on \$13.1M produces a 13.0% return on our equity. As we have already said, this segment on its own produces OK results, but I would certainly not describe it as compelling.

Now back to our exercise.

In 2018, we earned **\$0.5 million** of cash on \$40.2 million of revenue. As the North American category has been growing in revenue, at approximately 20% for the last three years, we model our cash in this segment based on the 20% year over year revenue growth rate in the category, net of the three year historical average gross margin and a fixed expense percentage in line with the fixed expenses discussed in Step 5. See below for results:

Table 16. Discounted Cash Flow Model Inputs 1.2

	Monthly cash generated from the average subscription pet	Total Pet Months	Total cash generated subscription pets	Total cash generated other pets	Total cash generated
2018 Actual	\$5.74	4,843,808	\$27.8M	\$0.5M	\$28.3M
2019 Actual	\$6.85	5,575,676	\$38.2M	\$1.7M	\$39.9M
2020	\$7.78	6,407,329	\$49.9M	\$1.6M	\$51.5M
2021	\$8.47	7,280,343	\$61.7M	\$2.3M	\$64.0M
2022	\$9.18	8,242,219	\$75.6M	\$3.1M	\$78.7M
2023	\$9.81	9,304,305	\$91.3M	\$4.0M	\$95.3M
2024	\$10.32	10,479,007	\$108.1M	\$4.8M	\$112.9M
2025	\$10.86	11,781,547	\$127.9M	\$5.7M	\$133.6M
2026	\$11.43	13,230,666	\$151.2M	\$6.9M	\$158.1M
2027	\$12.04	14,850,112	\$178.8M	\$8.2M	\$187.0M
2028	\$12.68	16,667,751	\$211.4M	\$9.9M	\$221.3M
2029	\$13.37	18,707,901	\$250.1M	\$11.8M	\$261.9M
2030	\$14.09	20,997,766	\$295.9M	\$14.3M	\$310.2M
2031	\$14.86	23,567,914	\$350.1M	\$17.2M	\$367.3M
2032	\$15.67	26,452,650	\$414.4M	\$20.8M	\$435.2M

Note that actual cash generated by our other business in 2019 was \$1.7M—an increase of \$1.1M over what the model would have predicted in 2018, because this segment grew more than 20% in 2019.

STEP 7

Determine how much of our discretionary cash we should expect to spend to grow the number of enrolled pets.

In our model, our total acquisition spend for the subscription business is based on a per pet acquisition cost (PAC), multiplied by the number of new pets in a given year. We estimate this allowable pet acquisition cost based on the calculated internal rate of return (IRR) of our average pet. Our target IRR is between 30% and 40% for all new subscription pets.

Our pet acquisition cost is a one-time expense that we pay to enroll a new pet. These expenses are recorded as sales and marketing in our income statement. Unlike many business models, we do not have ongoing sales and marketing expense for renewing pets. We pay a small, on-going residual to our Territory Partners, but those expenses are recorded as a part of our variable expenses.

For a given period of time, we take our total sales and marketing expense minus our one-time enrollment sign-up fee, and divide it by the number of new pets. This is our methodology to calculate our average pet acquisition cost (PAC). Several years ago, the majority of our sales and marketing spend was directed at creating leads. Today our pet acquisition costs are split between the costs associated with creating long-term lead sources and the costs of converting these leads.

Table 17. Discretionary Cash Available For Acquisition Spend, Per Pet

	Contribution profit over the life of an average pet	Fixed expenses over the life of an average pet	Total profit over the life of the average pet*	PAC	Lead ¹	Convert ²
2016	\$631	\$341	\$290	\$123	85%	15%
2017	\$727	\$318	\$409	\$152	75%	25%
2018	\$710	\$261	\$449	\$164	60%	40%
2019	\$753	\$230	\$523	\$212	50%	50%

¹Please note that in our filings, we refer to this as our key metric called "LVP, including fixed expenses." We have titled this column to align with the row titled "Profit Per Pet Per Month" in Table 11 of this letter.

²Historically, we have not tracked the attribution between our lead and conversion costs. Therefore, the percentages in Table 17 are internal management estimates.

To determine the overall acquisition spend in the model, we break out our costs into two buckets. The first bucket is for the new pets we estimate will enroll through the **refer-a-friend** and **add-a-pet** channels. This is an important cohort of our new enrollments that we monitor and report regularly. For several years, 0.7% of our total book consistently enrolled a new pet each month by either adding a new pet to their policy or referring a friend with a new pet. For this model, we calculate our allowable spend at a 30% IRR and estimate that we will spend **50%** of that amount on this first bucket of pets. We estimate this at 50%, given that we incur virtually no lead expense associated with these new pets as they are directly referred from, or added by, our existing members, and this level of spend is consistent with our historical estimates.

Refer-A-Friend: Members who learned about Trupanion from their friend or relative, who recommended that they also enroll. Refer-a-friend historically grows as a percentage of total pets enrolled.

Add-A-Pet: Members who already have a pet enrolled and choose to enroll another pet. Add-a-pet historically grows as a percentage of total pets enrolled.

For the remaining new pets that enroll, we assume they will come at the bottom end of our allowable IRR range, which is 30%. In 2018, approximately 74% of our new enrollments were acquired outside of members adding pets or referring friends. It is the blend of these two cohorts that gave us a 46% IRR in 2018.

To break this down further, let me reference back to our earlier discussion beginning on page 17, "Why we add a 1% capital charge."

“ Our average lifetime retention of a pet was 71.4 months in 2018. $71.4 \text{ months} \times \$5.74 = \$409.84$. We spent \$23 million dollars one-time enrolling approximately 126,000 new subscription pets in 2018 that, excluding sign-up fees, averages to \$164 spent per pet. Investing \$164 once to get \$409.84 in return is a 250% return on your invested capital. Because it takes 71 months to earn back that capital, the 250% return equates to an estimated 46% average return per year, which we describe as our internal rate of return (IRR).

Table 18. Discounted Cash Flow Model Inputs 1.3

	Monthly cash generated from The Average subscription pet	Total Pet Months	Total cash generated subscription pets	Total cash generated other pets	Total cash generated	Acquisition spend minus sign up fee	Cash after acquisition spend
2018 Actual	\$5.74	4,843,802	\$27.8M	\$0.5M	\$28.3M	\$21.1M	\$7.2M
2019 Projected	\$7.02	5,602,431	\$39.3M	\$0.6M	\$39.9M	\$30.4M	\$9.5M
2019 Actual	\$6.85	5,575,670	\$38.2M	\$1.7M	\$39.9M	\$30.4M	\$9.5M
2020	\$7.78	6,407,329	\$49.9M	\$1.6M	\$51.5M	\$38.4M	\$13.1M
2021	\$8.47	7,280,343	\$61.7M	\$2.3M	\$64.0M	\$46.7M	\$17.3M
2022	\$9.18	8,242,219	\$75.6M	\$3.1M	\$78.7M	\$56.5M	\$22.2M
2023	\$9.81	9,304,305	\$91.3M	\$4.0M	\$95.3M	\$67.4M	\$27.9M
2024	\$10.32	10,479,007	\$108.1M	\$4.8M	\$112.9M	\$79.1M	\$33.8M
2025	\$10.84	11,781,547	\$127.9M	\$5.7M	\$133.6M	\$93.0M	\$40.6M
2026	\$11.43	13,230,666	\$151.2M	\$6.9M	\$158.1M	\$109.5M	\$48.6M
2027	\$12.04	14,850,112	\$178.8M	\$8.2M	\$187.0M	\$129.3M	\$57.7M
2028	\$12.68	16,667,751	\$211.4M	\$9.9M	\$221.3M	\$153.0M	\$68.3M
2029	\$13.37	18,707,901	\$250.1M	\$11.8M	\$261.9M	\$180.9M	\$81.0M
2030	\$14.09	20,997,766	\$295.9M	\$14.3M	\$310.2M	\$214.2M	\$96.0M
2031	\$14.86	23,567,914	\$350.1M	\$17.2M	\$367.3M	\$253.4M	\$113.9M
2032	\$15.67	26,452,650	\$414.4M	\$20.8M	\$435.2M	\$300.0M	\$135.2M

We highlight that actual acquisition spend in 2019, less sign-up fee revenue, was **\$30.4M** which is exactly what we had projected in our model in 2018.

The last component of the 15 year discounted cash flow model is to **determine the “steady” state or “terminal year” value.**

In the above model, we project pet (month) growth for the first five years (after the current year) based on active hospital and same store sales assumptions. We then project pet months in the remaining years at a constant growth rate (until the terminal year) based on the preceding trend in pet months. For 2019, this results in an approximate 12.2% average pet (month) growth rate in the outer years. When combined with a 5.5% annual increase in our cash earned per pet (ARPU), this results in an 18.4% year over year increase in revenue in these years.

In the remaining terminal year, we have assumed that our total enrolled pet count remains flat at 2.3M subscription pets enrolled, or zero net new pets. Assuming the continued 5.5% increase in veterinary costs due to inflation, the revenue growth rate would drop from 18.4% to 5.5%. Note that, despite zero net new pets, the pet months increase slightly in the terminal year due to mid-year enrollments from the prior year being enrolled for a full year in the terminal year.

The terminal year assumptions for retention and expenses are consistent with the methodology discussed in the previous steps, with the exception of the estimated 1% capital charge and assumptions around other business.

Since the terminal year assumes less growth (zero net new pets), the capital charge assumption in the terminal year is reduced from 1% to 0.75% of revenue. Similar to the subscription business, where minimal growth is assumed in the terminal year, the other business revenue growth assumption is reduced from 20% to 5%.

Terminal Year: This concept is used in the last year of a DCF model to signify the margin profile of a business when it moves from a growth mode to a steady state.

In the terminal year, there would be **\$461.8M** in cash earned from subscription pets assuming a 5.5% increase in ARPU, resulting in **\$16.51** of monthly cash generated from the average subscription pet.

Table 19. Discounted Cash Flow Model Inputs 1.4

	Monthly cash generated from the average subscription pet	Total Pet Months	Total cash generated subscription pets	Total cash generated other pets	Total cash generated
2019 Actual	\$6.85	5,575,670	\$38.2M	\$1.7M	\$39.9M
2020	\$7.78	6,407,329	\$49.9M	\$1.6M	\$51.5M
2021	\$8.47	7,280,343	\$61.7M	\$2.3M	\$64.0M
2022	\$9.18	8,242,219	\$75.6M	\$3.1M	\$78.7M
2023	\$9.81	9,304,305	\$91.3M	\$4.0M	\$95.3M
2024	\$10.32	10,479,007	\$108.1M	\$4.8M	\$112.9M
2025	\$10.86	11,781,547	\$127.9M	\$5.7M	\$133.6M
2026	\$11.43	13,230,666	\$151.2M	\$6.9M	\$158.1M
2027	\$12.04	14,850,112	\$178.8M	\$8.2M	\$187.0M
2028	\$12.68	16,667,751	\$211.4M	\$9.9M	\$221.3M
2029	\$13.37	18,707,901	\$250.1M	\$11.8M	\$261.9M
2030	\$14.09	20,997,766	\$295.9M	\$14.3M	\$310.2M
2031	\$14.86	23,567,914	\$350.1M	\$17.2M	\$367.3M
2032	\$15.67	26,452,650	\$414.4M	\$20.8M	\$435.2M
Terminal year	\$16.51	27,978,852	\$461.8M	\$23.9M	\$485.7M

In the terminal year, at a 30% internal rate of return, our target PAC spend would be **\$620** per pet. To achieve steady state growth in our terminal year, we would need to replenish 28,939 enrolled pets per month (the result of a 1.24% monthly churn rate). In our DCF model, we assume that 16,321 new pets per month, or 0.7% of the book, will come from existing pet owners adding pets or referring their friends. For the model, we have assumed these pets were acquired at 50% of our allowable PAC (or **\$310**), as they would not require lead generation costs. The remaining 12,618 new pets per month would come in at our allowable PAC spend of \$620. This results in a blended PAC spend of \$445 per pet for the combined cohorts. See the chart below.

Table 20. Terminal Year Cash After PAC Spend

	New enrollments, terminal year	PAC	
Terminal year cash generated			\$485.7M*
Refer-a-friend & add-a-pet acquisition spend	195,852	(\$310)	(\$60.7M)
New pet acquisition spend	151,411	(\$620)	(\$93.9M)
Net profit in terminal year			\$331.3M

*Excludes sign-up fees.

In the terminal year, the model would predict a **\$331.3M** net profit before taxes.

Table 21. Discounted Cash Flow Model Inputs 1.5

	Monthly Cash Generated From The Average Subscription Pet	Total Pet Months	Total Cash Generated Subscription Pets	Other Pets	Total Cash Generated	PAC spend minus sign up fee	Cash after PAC spend
2019 Actual	\$6.85	5,575,670	\$38.2M	\$1.7M	\$39.9M	\$30.4M	\$9.5M
2020	\$7.78	6,407,329	\$49.9M	\$1.6M	\$51.5M	\$38.4M	\$13.1M
2021	\$8.47	7,280,343	\$61.7M	\$2.3M	\$64.0M	\$46.7M	\$17.3M
2022	\$9.18	8,242,219	\$75.6M	\$3.1M	\$78.7M	\$56.5M	\$22.2M
2023	\$9.81	9,304,305	\$91.3M	\$4.0M	\$95.3M	\$67.4M	\$27.9M
2024	\$10.32	10,479,007	\$108.1M	\$4.8M	\$112.9M	\$79.1M	\$33.8M
2025	\$10.86	11,781,547	\$127.9M	\$5.7M	\$133.6M	\$93.0M	\$40.6M
2026	\$11.43	13,230,666	\$151.2M	\$6.9M	\$158.1M	\$109.5M	\$48.6M
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2029	\$13.37	18,707,901	\$250.1M	\$11.8M	\$261.9M	\$180.9M	\$81.0M
2030	\$14.09	20,997,766	\$295.9M	\$14.3M	\$310.2M	\$214.2M	\$96.0M
2031	\$14.86	23,567,914	\$350.1M	\$17.2M	\$367.3M	\$253.4M	\$113.9M
2032	\$15.67	26,452,650	\$414.4M	\$20.8M	\$435.2M	\$300.0M	\$135.2M
Terminal Year	\$16.51	27,978,852	\$461.8M	\$23.9M	\$485.7M	\$154.4M	\$331.3M

Table 22. Terminal Year P&L

Subscription revenue	\$3,393M	
Other revenue	\$874M	
Total revenue	\$4,267M	100%
Cash earned after capital charge	\$486M	11%
- PAC	(\$154M)	4%
=Net profit before taxes	\$331M	8%

In our 2019 model shown above, in 2033, the terminal year, we would have 2.3 million subscription pets with an average monthly revenue per pet of \$122. The model shows total revenue of **\$4,267 million** and a net profit before taxes of **\$331 million** in the terminal year of 2033.

Based on the present value of cash generated each year, a discount rate of **10.8%** (which we consider appropriate based on our calculated weighted average cost of capital), and the terminal year results, the model would indicate an intrinsic value in 2019 of \$1.26 billion. Additionally, we include the present value of cash flows we expect to generate during the 15 year period from our insurance entity purchasing full ownership of our home office building, which totals \$25.7M. This is a total intrinsic value in 2019 of **\$1.29 billion**. Our fully diluted share count (which includes all unvested shares and unexercised options) at the end of 2019 was 37,626,938. This equates to an intrinsic value per fully diluted share of \$34.21, since using the fully diluted share count is the most conservative view. If you wanted to calculate our intrinsic value using **outstanding shares** instead, it would have been \$36.45 at the end of 2019. Internally, we are more focused on our intrinsic value using our fully diluted share count when determining the value of our business, as well as the change from the prior year.

One could argue our cost of equity should be higher or lower. While we view 10.8% as conservative, a sensitivity analysis results in the following:

Table 23. Valuation Sensitivity Analysis

Discount rate		9.8%	10.8%	11.8%
Terminal growth rate	4.5%	\$1.56B	\$1.20B	\$0.96B
	5.0%	\$1.69B	\$1.29B	\$1.01B
	5.5%	\$1.86B	\$1.38B	\$1.07B

If going into a year, or a string of years, our model were to indicate that the predicted year-over-year change in our intrinsic value per share was to be below an acceptable return, then we would need to adjust our strategy to positively impact our key metrics.

What is an acceptable return? From my perspective, as a publicly traded **small-cap company** in a large under-penetrated market, we would expect to deliver out-sized returns to that of an **index fund**; otherwise, one would not accept the added risk. 15% is our floor. At 20% we are happy, and at 25% we are doing back-flips.

Outstanding Shares: Stock that is fully owned by all of our stockholders.

Terminal Growth Rate: The perpetual rate of growth we would expect of our business when it hits a steady state.

Small-Cap Company: Publicly traded company with a market value of less than \$5 billion.

Index Fund: An investment vehicle where one can own an equal percentage of all of the public companies included in the index fund, therefore getting an average return on investment on all of those publicly traded companies.

Common sense disclosure

We have provided this explanation of how we calculate intrinsic value for our company to help you in your own analysis and investment process. Our method is continually being refined. We hope we can share this information with you in a way that does not result in us, or other public companies, needing to be less transparent in the future.

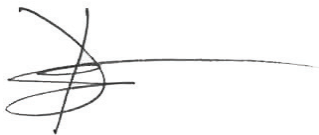
In Closing

As the CEO of Trupanion, it is my intention to share our key metrics as transparently as possible.

It is not my intention to provide annual updates to our intrinsic value model analysis, nor is it my intention to share our perspective on the resulting value per share publicly in the future. Be confident that we are monitoring our key metrics, the underlying health of our business, and the year over year change in intrinsic value per share the best way we know how.

For me, our core monthly subscription business is like "groundhog month." The recurring nature of our business model allows for incremental improvements of individual initiatives. Higher ARPU, more active hospitals, improved same store sales, expansion in our adjusted operating margin, reduced churn, and greater member referrals and new pets added are the key metrics that will help us outperform. When success in each of these areas is combined, it is not unthinkable to me that we could achieve the near impossible...or nirvana.

Kuyashii,

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

Darryl Rawlings

Founder & Chief Executive Officer

END NOTES

In this letter and our other publicly available reports, we present certain non-GAAP measures, including adjusted EBITDA, variable expenses, fixed expenses, adjusted operating income, adjusted operating margin, acquisition cost, and free cash flow. These non-GAAP financial measures may not provide information that is directly comparable to that provided by other companies in our industry as other companies in our industry may calculate or use non-GAAP financial measures differently. In addition, there are limitations in using non-GAAP financial measures because they are not prepared in accordance with GAAP and exclude expenses that may have a material impact on Trupanion's reported financial results. The presentation and utilization of non-GAAP financial measures is not meant to be considered in isolation or as a substitute for the directly comparable financial measures prepared in accordance with GAAP. Trupanion urges its investors to review the reconciliation of its non-GAAP financial measures to the most directly comparable GAAP financial measures in its consolidated financial statements, and not to rely on any single financial or operating measure to evaluate its business. These reconciliations are included within our Supplemental Financial Information provided on Trupanion's Investor Relations website.

Our internal rate of return is calculated assuming the new pets we enroll during the year will behave like an average pet. Specifically, our 2019 calculation assumes adjusted operating income (calculated as the average monthly revenue for new pets of \$57.52 factored by the adjusted operating margin of 11.5%) for an average subscriber life of 70.4 months (calculated as the quotient obtained by dividing one by the churn rate, which equals one minus the average monthly retention rate of 98.58%).

Because of varying available valuation methodologies, subjective assumptions and the variety of equity instruments that can impact a company's non-cash expenses, Trupanion believes that providing various non-GAAP financial measures that exclude stock-based compensation expense and depreciation and amortization expense allows for more meaningful comparisons between its operating results from period to period. Trupanion offsets sales and marketing expense with sign-up fee revenue in the calculation of net acquisition cost because it collects sign-up fee revenue from new members at the time of enrollment and considers it to be an offset to a portion of Trupanion's sales and marketing expenses. Trupanion believes this allows it to calculate and present financial measures in a consistent manner across periods. Trupanion's management believes that the non-GAAP financial measures and the related financial measures derived from them are important tools for financial and operational decision-making and for evaluating operating results over different periods of time.

DISCLAIMER

This letter contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and section 27A of the Securities Act of 1933, as amended (Securities Act). All statements contained in this letter other than statements of historical fact, including statements regarding lifetime values of a pet, discounted cash flows and our intrinsic value model, future results of operations and financial position (including ARPU, AOM, AOI, IRR, PAC, new pets enrolled, retention and churn, active hospitals, international expansion, veterinary invoices, and variable and fixed expenses) our business strategy and plans and our objectives for future operations. In particular, this letter extensively discusses our internal discounted cash flow model, and you should regard substantially all parts of this discussion as forward-looking statements. In addition, the are forward-looking statements. The words "anticipate," "believe," "continue," "could," "estimate," "expect," "intend," "may," "model," "plan," "potentially," "predict," "project," "target," "will," "would," and similar expressions that convey uncertainty of future events or outcomes, are intended to identify forward-looking statements.

These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including risks relating to:

- our net losses since inception, our ability to maintain revenue growth, maintain profitability, obtain returns on our investments in pet acquisition, and other financial risks;
- our ability to attract online visitors, grow or member base, and maintain retention rates;
- our ability to maintain relationships with Territory Partners, veterinarians and strategic partners;
- our ability to remain competitive and maintain brand recognition;
- our ability to scale our infrastructure, manage our growth, budget for veterinary invoice expenses, and other business risks;
- our other business;
- security breaches, payment processing, and related technology and intellectual property matters;
- compliance with risk-based capital and other regulations;
- litigation or regulatory proceedings;
- dependence on key personnel;
- compliance with covenants in our credit agreement;
- international operations, including exchange rates;
- investments or acquisitions, owning an office building, and other strategic matters;
- tax, accounting and general economic matters;
- being a public company; and
- ownership of our common stock; and
- those described under the heading "Risk Factors" in our Annual Report on Form 10-K and other filings we make from time to time with the Securities and Exchange Commission.

Moreover, we operate in a very competitive and rapidly changing environment, and new risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this letter may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

You should not rely on forward-looking statements as predictions or guarantees of future events. Although we believe that the assumptions and expectations reflected in the forward-looking statements are reasonable based on our historical experience, these assumptions and expectations involve significant judgment and uncertainty, and in some cases these assumptions and expectations (and therefore the judgment and uncertainty) have been projected over an extended period of time. Future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements may not be achieved or occur. We undertake no obligation to update publicly any forward-looking statements for any reason, except as required by law.



2019 Form 10-K

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2019

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from ____ to ____

Commission File Number: 001-36537

TRUPANION, INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of incorporation or organization)

83-0480694

(I.R.S. Employer Identification Number)

**6100 4th Avenue S, Suite 200
Seattle, Washington 98108**

(855) 727 - 9079

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Securities registered pursuant to Section 12(b) of the Act:

<u>Title of Each Class</u>	<u>Trading Symbol</u>	<u>Name of Exchange on Which Registered</u>
Common stock, \$0.00001 par value per share	TRUP	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ☒ Yes ☐ No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ☐ Yes ☒ No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. ☒ Yes ☐ No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

☒ Yes ☐ No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ☒

Non-accelerated filer ☐

Accelerated filer ☐

Smaller reporting company ☐

Emerging growth company ☐

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

The aggregate market value of the registrant's common stock held by non-affiliates as of June 30, 2019, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$1,174,944,132 using the closing price on that day of \$36.13.

As of February 6, 2020, there were approximately 34,958,851 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE Part III incorporates certain information by reference from the definitive proxy statement to be filed by the registrant in connection with the 2019 Annual Meeting of Stockholders (Proxy Statement). The Proxy Statement will be filed by the registrant with the Securities and Exchange Commission pursuant to Regulation 14A not later than 120 days after the end of the registrant's fiscal year ended December 31, 2019.

TRUPANION, INC.
Annual Report on Form 10-K
For the Fiscal Year Ended December 31, 2019
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Note About Forward-Looking Statements

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, and section 27A of the Securities Act of 1933, as amended (Securities Act). All statements contained in this Annual Report on Form 10-K other than statements of historical fact, including statements regarding our future results of operations and financial position, our business strategy and plans and our objectives for future operations, are forward-looking statements. The words “believe,” “may,” “will,” “potentially,” “estimate,” “target,” “continue,” “anticipate,” “intend,” “could,” “would,” “project,” “plan” and “expect,” and similar expressions that convey uncertainty of future events or outcomes, are intended to identify forward-looking statements.

These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Part I. Item 1A. “Risk Factors” and elsewhere in this Annual Report on Form 10-K. Moreover, we operate in a very competitive and rapidly changing environment, and new risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Annual Report on Form 10-K may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements.

You should not rely on forward-looking statements as predictions of future events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements will be achieved or occur. We undertake no obligation to update publicly any forward-looking statements for any reason, except as required by law.

Unless otherwise stated or the context otherwise indicates, references to “we,” “us,” “our” and similar references refer to Trupanion, Inc. and its subsidiaries taken as a whole.

PART I

Item 1. Business

Our Mission

Our mission is to help the pets we all love receive the best veterinary care.

Company Overview

We provide medical insurance for cats and dogs throughout the United States, Canada and Puerto Rico. Our data-driven, vertically-integrated approach enables us to provide pet owners with what we believe is the highest value medical insurance for the life of their pets, priced specifically for each pet's unique characteristics.

We operate in two business segments: subscription business and other business. We generate revenue in our subscription business segment primarily from subscription fees for our medical insurance, which we market to consumers. Fees are paid at the beginning of each subscription period, which automatically renews on a monthly basis. We generate revenue in our other business segment by writing policies on behalf of third parties. We do not undertake the marketing efforts for these policies but have a business-to-business relationship with these third parties. Our other business segment also includes revenue from companies or organizations who choose to offer medical insurance for cats and dogs as a benefit to their employees or members. The products in our other business segment may be materially different from our subscription business. For the years ended December 31, 2019, 2018, and 2017 we generated 83.7%, 86.8%, and 90.0% of our revenue through subscription fees for our medical insurance for cats and dogs, and 16.3%, 13.2% and 10.0% of our revenue through our other business segment.

Our Business

It is very difficult for pet owners to budget for veterinary expenses when their pets become sick or injured. Pet owners do not know whether their pet's health will be "average," "lucky," or "unlucky." Over the life of a pet, veterinary expense for a lucky vs. unlucky pet can vary from \$500 to more than \$50,000. Even if a pet ends up being "average" over its life, the timing of accidents or illnesses may not align with the owner's budgeting approach. Further, many pet owners do not know how to budget for the "average" cost of medical care for their pets. Average veterinary expenses often greatly exceed the expectations of the pet owner and vary dramatically based on a multitude of factors, including the availability of care by region and the types of treatments advisable for specific pet breeds. Consequently, self-insuring is not an effective solution for many individual pet owners.

Our subscription plan was designed by veterinarians to enable them to recommend the optimal treatment for the pet, without having their decisions dictated by the cost of treatment. As a result, we believe our subscription plan enables veterinarians to establish stronger ties and better alignment with their clients. Our members tend to visit their veterinarian more frequently and spend more money on the best course of treatment for their pet. This results in better health outcomes for pets, which we believe creates a flywheel effect that has been the key driver of growth for our subscription business.

Our subscription business's cost-plus model is designed to spread the risk evenly within each category of pets so our members can budget for unexpected veterinary costs. We have been collecting comprehensive pet health data for approximately 20 years. We believe our data and approach to pricing is unmatched and it provides us with a greater understanding of anticipated veterinary costs. We leverage this to price our subscription plan for each pet based on their specific circumstances such as breed, age (at enrollment), geography, and desired deductible so that, in aggregate, the amounts paid by owners of lucky pets helps to cover the veterinary costs incurred by unlucky pets. We believe our actuarial team, working with our granular data, is able to price our subscription plan much more accurately than any other player in the industry so that we can provide our members with the highest value proposition.

In addition to pricing our subscription plan based on years of comprehensive pet health data, our subscription plan has been designed to provide the highest target payout ratio available (what we spend paying veterinary invoices) and delivers the broadest coverage available. Our plan pays 90% of eligible costs relating to any illnesses and injuries.

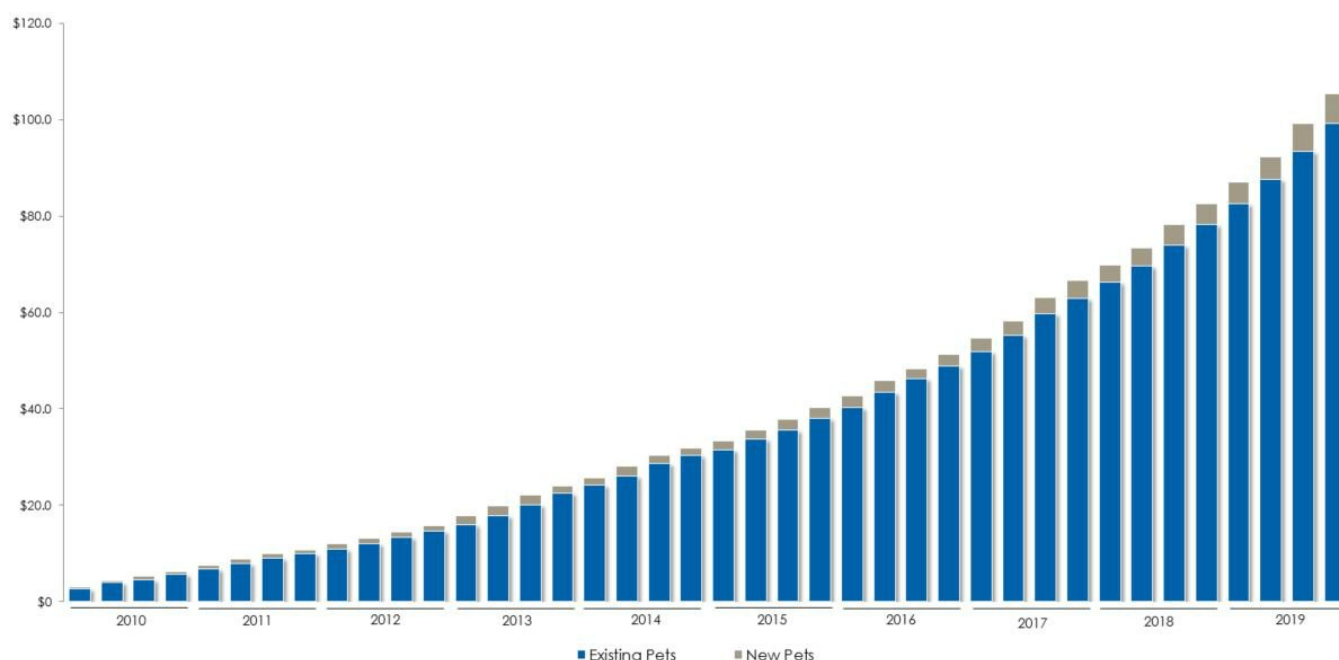
We also provide a differentiated customer experience to our members, including our proprietary, patented software that is designed to communicate directly with a veterinary hospital's practice management software. Invoices are often approved in seconds so the participating veterinarian's clients pay only their 10% portion of eligible veterinary invoice costs while we pay the rest of the balance directly to the hospital. We believe this unique solution, which is offered free to veterinarians and pet owners, transforms the insurance experience.

Due to our focus on providing a superior value proposition and member experience, our members have been extremely loyal. Since 2010, we have a 98.5% average monthly retention rate. Our growing and loyal membership base provides us with highly predictable and recurring revenue. We operate our subscription business segment similar to other subscription-based businesses, with a focus on achieving a target margin prior to our pet acquisition expense and then maximizing the estimated internal rate of return for an average pet on our pet acquisition expenses.

Our target market is large and under-penetrated. According to the Insurance Information Institute, there are 183.9 million household dogs and cats in the United States, and according to the Canadian Animal Health Institute, there are 16.5 million in Canada. North American Pet Health Insurance Association estimates that the penetration rate for medical insurance for cats and dogs in North America is approximately one to two percent. We believe that over the long-term, the North American penetration rate can reach levels comparable to the U.K., where, according to Global Market Insights, approximately one in four cats and dogs has medical insurance.

Our total enrolled pets grew from 31,207 pets on January 1, 2010 to 646,728 pets on December 31, 2019, which represents a compound annual growth rate of 35%. As a result, our revenue has grown from \$19.1 million in 2010 to \$383.9 million in 2019.

**Total Revenue by New and Existing Pets Enrolled
(in millions)**



Our Strategy

We are focused on attracting and retaining members by providing a best-in-class value and member experience. In particular, we are focused on the following:

Increasing the number of veterinary hospitals as a source of leads. We intend to increase the number of veterinary hospitals that are helping their clients learn about high quality medical insurance, primarily by leveraging our Territory Partners and by increasing the number of veterinary hospitals using our software.

Increasing the number of leads per veterinary hospital. We intend to continue increasing the rate at which active veterinary hospitals refer leads to us primarily by improving our relationships over time including through our Territory Partners, internal hospital support team and software

Increasing the number of referrals from members. We believe that it is critical to our long-term success that existing members add a pet or refer their friends and family to Trupanion, so we focus on improving the member experience, including increasing the percentage of claims that are processed rapidly at checkout and paid directly to veterinarians through our patented, proprietary software.

Improving conversion. We are investing to increase the rate at which we convert pet owners receiving quotes for our subscription plan into enrolled members.

Improving retention, particularly in the first 90 days of an enrollment. Member retention is a key part of our strategy. Historically, members in their first 90 days of membership have the lowest retention rate. We are investing in the education process and improving initial customer communication and experiences in order to increase our retention rates.

Automating the payment of veterinary invoices. We have developed algorithms to leverage the data from our software so we can automate the payment of veterinary invoices. We intend to increase the percentage of veterinary invoices paid without human intervention with the goal of ensuring that we can do so without reducing the quality of our decision making on a case-by-case basis.

Exploring other member acquisition channels. We regularly evaluate new member acquisition channels. We intend to pursue those new channels that we believe could, over time, deliver our desired return on investment.

Expanding internationally. While we are primarily focused on capturing the large opportunity in the U.S. and Canadian markets, we recently entered the Australian market through a joint-venture, and we continue to explore other international expansion opportunities.

Pursuing other revenue opportunities. We intend to continue to leverage our competitive advantages to generate revenue. For example, within our other business segment, our wholly-owned insurance subsidiary, American Pet Insurance Company, has partnered with unaffiliated general agents offering pet insurance products since 2012. In addition, we have been pursuing and intend to continue to pursue opportunities to provide pet owners with complementary products and services. For example, we have invested in a pet food initiative to explore whether pets on a calorie-controlled, high-quality diet have improved health outcomes that can justify a decrease in the cost of their subscription plan.

Sales and Marketing

We believe that support from veterinarians is critical to driving broader acceptance of medical insurance for pets in North America and our strategy is based on this belief. Since 2003, we have engaged “Territory Partners” charged with cultivating relationships with veterinarians and building awareness among the veterinary community of the benefits that our subscription plan offers both veterinarians and their clients. Our Territory Partners are independent contractors who market our product and are paid fees based on activity in their regions. Their role is to create meaningful, long-term relationships with veterinarians and to educate those veterinarians about the benefits of high-quality medical insurance for the veterinarians’ base of clients. We believe this structure aligns our interests and provides a platform that we can leverage over time.

Our Territory Partner approach is unique and unmatched in our industry. We believe that it would be extremely difficult, costly and time consuming for a competitor to replicate.

We generate leads through a diverse set of member acquisition channels, which we then convert into members primarily through our contact center, website and other direct-to-consumer activities. These channels primarily include leads from third-parties such as veterinarians and referrals from existing members.

Competition

We compete primarily with credit card companies, which enable pet owners to self-fund veterinary costs on an emergency basis, as well as new and existing pet insurance brands. The vast majority of pet owners in the United States and Canada do not currently have medical insurance for their pets and there is very little movement from one insurance company to another due to pre-existing conditions. As a result, we are focused primarily on expanding the overall size of the market by providing pet owners with the highest value proposition and the broadest coverage. We view our primary competitive challenge as educating pet owners on why Trupanion is a better alternative to self-insuring.

We have been competing against at least 20 brands at any one time in our operating history. In our experience, competing pet insurance companies generally fall into one of two segments: (a) traditional providers with low target price points and narrow coverage that is unlikely to cover things like congenital and hereditary conditions, and (b) higher-value providers that provide some form of an annual plan designed to increase the cost of the plan as the pet ages.

We believe that we have competitive advantages that position us favorably. These include: broader coverage and a superior value proposition due, in part, to our vertically integrated structure that reduces frictional costs, a unique member acquisition strategy that leverages the relationships our Territory Partners have developed in the veterinary community, a proprietary database containing 20 years of comprehensive pet health data enabling us to be more precise in our pricing and pet acquisition expense, and our patented, proprietary software which allows us to pay veterinary invoices directly at time of treatment.

Intellectual Property

We rely on federal, state, common law, and international rights, as well as contractual restrictions, to protect our intellectual property. We control access to our proprietary technology, software, and documentation by entering into confidentiality and invention assignment agreements with our employees and partners, and confidentiality and, in some cases, exclusive agreements with third parties, such as service providers, vendors, individuals and entities that may be exploring a business relationship with us. We also rely on a combination of intellectual property rights, including trade secrets, patents, copyrights, trademarks, and domain names to establish and protect our intellectual property. We seek to protect our proprietary position by filing patent applications in the United States and in jurisdictions outside of the United States related to our technology, inventions, and improvements that are important to our business. We hold two U.S. utility patents and one U.S. design patent related to our proprietary software, and we have multiple additional patent applications pending in the United States and in other jurisdictions. We additionally rely on data and market exclusivity, and patent term extensions when available. Our ability to protect and enforce our intellectual property rights is subject to risk and our failure to do so may adversely impact our business.

Employees

Our company culture and team is critical to our continued success. We are a mission-driven company and attract employees that share our passion for pets. Our culture enables our employees to channel that passion collectively toward our goals. As of December 31, 2019, we had 738 employees.

Regulation

United States Regulations

U.S. federal law and the laws and regulations of each United States state, territory and possession apply to companies licensed to transact insurance business in these jurisdictions. While our insurance subsidiary and underwriter, American Pet Insurance Company (APIC), is domiciled in New York State and its primary regulator is, therefore, the New York Department of Financial Services (NY DFS), APIC is also currently licensed to do business in all 50 states, Puerto Rico and the District of Columbia. As such, APIC is also subject to comprehensive regulation and supervision under laws and regulations of each U.S. state, territory, and possession.

Because APIC is domiciled in New York, APIC is subject to laws governing insurance holding companies in New York. These laws, among other things, require that we file periodic information reports with the NY DFS, including information concerning our capital structure, ownership, financial condition and general business operations; limit our ability to enter into transactions between APIC and our other affiliated entities; restrict the ability of any one person to acquire certain levels of our voting securities without prior regulatory approval; and restrict APIC's ability to pay dividends to its holding company parent.

Other state regulators also have broad authority to perform on-site market conduct examinations of our management and operations, marketing and sales, underwriting, customer service, claims handling and licensing. Regulators may perform market conduct examinations by visiting our facilities for a period of time to identify potential regulatory violations, discuss and correct identified violations, or to obtain a better understanding of how we operate in the marketplace. Further, U.S. state insurance laws and regulations require APIC to file financial statements with state insurance regulators in each state where it is licensed and its operations and accounts are subject to examination at any time. APIC prepares statutory financial statements in accordance with accounting practices and procedures prescribed or permitted by these regulators. The National Association of Insurance Commissioners (NAIC) has approved a series of uniform statutory accounting principles (SAP) that have been adopted, in some cases with minor modifications, by all state insurance regulators. As a basis of accounting, SAP was developed to monitor and regulate the solvency of insurance companies. When developing SAP, insurance regulators were primarily concerned with assuring an insurer's ability to pay all its current and future obligations to policyholders. As a result, statutory accounting focuses on conservatively valuing the assets and liabilities of insurers, generally in accordance with standards specified by the insurer's state of domicile. The financial statements included in this document are prepared in accordance with U.S. generally accepted accounting principles. The values for assets, liabilities and equity reflected in these financial statements are usually different from those reflected in financial statements prepared under SAP.

U.S. federal law generally does not directly regulate the insurance industry. However, from time to time, various federal regulatory and legislative changes have been proposed. Among the proposals that have in the past been, or are at present may be under consideration, are the possible introduction of federal regulation in addition to, or in lieu of, the current system of state regulation of insurers.

In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established a Federal Insurance Office within the U.S. Department of the Treasury. The Federal Insurance Office initially was charged with monitoring all aspects of the insurance industry (with exceptions for certain types of insurance), gathering data and conducting a study on methods to modernize and improve the insurance regulatory system in the United States. It is not possible to predict whether, in what form or in what jurisdictions any of these proposals might be adopted, or the effect federal involvement in insurance will have, if any, on us.

Industry Regulations

The NAIC adopted risk-based capital requirements for life, health and property and casualty insurance companies. APIC is subject to these risk-based capital requirements that require us to maintain certain levels of surplus \$55.3 million as of December 31, 2019 to support our overall business operations in consideration of our size and risk profile. If we fail to maintain the amount of risk-based capital required, we will be subject to additional regulatory oversight. To comply with these regulations, we may be required to maintain capital that we would otherwise invest in our growth and operations. Refer to Item 1A. “Risk Factors” for additional details of these requirements.

Further, NAIC developed a set of financial relationships or tests known as the Insurance Regulatory Information System, or IRIS, to assist state regulators in monitoring the financial condition of U.S. insurance companies. As of December 31, 2019, APIC had three IRIS ratios outside the usual range, relating to net premiums written to surplus, change in policyholders’ surplus, and investment yield. While a ratio outside the usual range is not considered a failing result, regulators may investigate or monitor an insurance company if its IRIS ratios fall outside the prescribed usual range.

Other Jurisdictions Regulations

In Canada, our insurance is written by an unaffiliated Canadian-licensed insurer, Omega General Insurance Company (Omega). Under the terms of our agreements with Omega, we retain any financial risk associated with our Canadian business. Omega’s Canadian insurance operations are supervised and regulated by Canadian federal, provincial and territorial governments and Omega is a fully licensed insurer in all of the Canadian provinces and territories in which we do business. In addition, we are required to fund a Canadian trust account in accordance with Canadian regulations. As of December 31, 2019, the account held CAD \$4.3 million.

We have a segregated cell business called Wyndham Segregated Account AX (WICL), located in Bermuda. WICL is regulated by the Bermuda Monetary Authority (BMA). Insurance companies with a presence in Bermuda are subject to solvency and liquidity standards, certain restrictions on the declaration and payment of dividends and distributions, certain restrictions on the reduction of statutory capital, and auditing and reporting requirements. In addition, BMA has the authority to supervise and, in certain circumstances, investigate and intervene in the affairs of insurance companies. Most significantly, Bermudan law restricts WICL’s ability to declare or pay dividends and the value of WICL’s assets must remain greater than the aggregate of its liabilities, issued share capital, and share premium accounts.

Corporate Information

We were founded in Canada in 2000 as Vetinsurance Ltd. In 2006, we effected a business reorganization whereby Vetinsurance Ltd. became a consolidated subsidiary of Vetinsurance International, Inc., a Delaware corporation. In 2007, we began doing business as Trupanion. In 2013, we formally changed our name from Vetinsurance International, Inc. to Trupanion, Inc. Our principal executive offices are located at 6100 4th Avenue South, Seattle, Washington 98108, and our telephone number is (855) 727-9079. Our website address is www.trupanion.com. Information contained on, or that can be accessed through, our website is not incorporated by reference, and you should not consider information on our website to be part of this Annual Report on Form 10-K.

Available Information

We are required to file annual, quarterly and other reports, proxy statements and other information with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934, as amended (Exchange Act). We also make available, free of charge on the investor relations portion of our website at investors.trupanion.com, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after they are filed electronically with the SEC. The SEC also maintains an Internet website at www.sec.gov where you can obtain our SEC filings. You can also obtain paper copies of these reports, without charge, by contacting Investor Relations at InvestorRelations@Trupanion.com.

Investors and others should note that we may announce material financial information to our investors using our investor relations website, SEC filings, our annual stockholder meeting, press releases, public conference calls, investor conferences, presentations and webcasts. We use these channels, as well as social media, to communicate with our members and the public about our company, our services and other issues. It is possible that the information we post on these channels, such as social media, could be deemed to be material information.

Item 1A. Risk Factors

Investing in our common stock involves a high degree of risk. You should carefully consider the risks and uncertainties described below, together with all of the other information in this report, including our consolidated financial statements and related notes, as well as in our other filings with the SEC, in evaluating our business and before investing in our common stock. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that are not expressly stated, that we are unaware of, or that we currently believe are not material, may also become important factors that affect us. If any of the following risks occur, our business, operating results, financial condition and prospects could be materially harmed. In that event, the price of our common stock could decline, and you could lose part or all of your investment.

Risks Related to Our Business and Industry

We have incurred significant cumulative net losses since our inception and may not be able to maintain profitability in the future.

We have incurred significant cumulative net losses since our inception. We incurred net losses of \$1.8 million and \$0.9 million in the years ended December 31, 2019 and 2018, respectively, and as of December 31, 2019, we had an accumulated deficit of \$85.5 million. We have funded our operations through equity financings, borrowings under a revolving line of credit and term loans and, since 2016, positive cash flows from operations. Our ability to maintain profitability will depend in significant part on our obtaining new members, retaining our existing members and ensuring that our expenses, including our sales and marketing expenses, does not exceed our revenue. We expect to make significant expenditures and investments in member acquisition. Our recent growth in revenue and membership may not be sustainable or may decrease, and we may not generate sufficient revenue to maintain profitability. Additionally, we budget for our expenses based, in significant part, on our estimates of future revenue and many of these expenses are fixed in the short term. As a result, we may be unable to adjust our spending in a timely manner if our revenue falls short of our estimates. Accordingly, any significant shortfall of revenue in relation to our estimates could have an immediate negative effect on our financial results.

We may not maintain our current rate of revenue growth.

Our revenue has increased quickly and substantially in recent periods. We believe that our continued revenue growth will depend on, among other factors, our ability to:

- improve our market penetration through cost-efficient and effective sales and marketing programs to attract new members;
- convert leads into enrollments;
- maintain high retention rates;
- increase the lifetime value per pet;
- maintain positive relationships with veterinarians and other lead sources;
- maintain positive relationships with and increase the number and efficiency of Territory Partners;
- continue to offer a superior value with competitive features and rates;
- price our subscriptions in relation to actual operating expenses and achieve required regulatory approval for pricing changes;
- recruit, integrate and retain skilled, qualified and experienced sales department professionals who can demonstrate our value proposition to new and existing members;
- provide our members with superior member service, including timely and efficient payment of veterinary invoices, and by recruiting, integrating and retaining skilled and experienced personnel who can efficiently review veterinary invoices and process payments;
- generate new and maintain existing relationships and programs in our other business segment;
- react to existing and new competitors;
- increase awareness of and positive associations with our brand; and
- successfully respond to and comply with regulations affecting our business and defend or prosecute any litigation.

You should not rely on our historical rate of revenue growth as an indication of our future performance.

We base our decisions regarding member acquisition expenditures primarily on the projected internal rate of return on marketing spend. Our estimates and assumptions may not accurately reflect our future results - we may overspend on member acquisition, and we may not be able to recover our member acquisition costs or generate profits from these investments.

We have made and plan to continue to make significant investments to grow our member base. We spent \$33.3 million on sales and marketing to acquire new members for the year ended December 31, 2019. Our average pet acquisition cost and the number of new pets we enroll depends on a number of factors and assumptions, including the effectiveness of our sales execution and marketing initiatives, changes in costs of media, the mix of our sales and marketing expenditures and the competitive environment. Our average pet acquisition cost has increased over time and has significantly varied in the past. In the future, our average pet acquisition cost may continue to rise and significantly vary period to period based upon specific marketing initiatives. We also regularly test new member acquisition channels and marketing initiatives, which often are more expensive than our traditional marketing channels and generally increase our average acquisition costs.

In addition, we base our decisions regarding our member acquisition expenditures primarily on our internal rate of return generated on an average pet. This analysis depends substantially on estimates and assumptions based on our historical experience with pets enrolled in earlier periods, including our key operating metrics. If our estimates and assumptions regarding our internal rate of return and the lifetime value of the pets that we project to acquire and our related decisions regarding investments in member acquisition prove incorrect, or if our calculation of internal rate of return and lifetime value of the pets that we project to acquire differs significantly from that of pets acquired in prior periods, we may be unable to recover our member acquisition costs or generate profits from our investment in acquiring new members. Moreover, if our member acquisition costs increase or we invest in member acquisition channels that do not ultimately result in any or an adequate number of new member enrollments, the return on our investment may be lower than we anticipate irrespective of the lifetime value of the pets that we project to acquire as a result of the new members. If we cannot generate profits from this investment, we may need to alter our growth strategy, and our growth rate and operating results may be adversely affected.

We depend in part on Internet search engines to attract potential new members to visit our website. If Internet search engines' methodologies are modified or our search result page rankings decline for other reasons, our new member growth could decline, and our business and operating results could be harmed.

We derive a significant amount of traffic to our website from consumers who search for pet medical insurance through Internet search engines, such as Google, Bing and Yahoo!. A critical factor in attracting consumers searching for pet medical insurance on the Internet to our website is whether we are prominently displayed in response to an Internet search relating to pet insurance. Algorithmic search result listings are determined and displayed in accordance with a set of formulas or algorithms developed by the particular Internet search engine, which may change from time to time. If we are listed less prominently in, or removed altogether from, search result listings for any reason, the traffic to our websites would decline and we may not be able to replace this traffic, which in turn would harm our business, operating results and financial condition. If we decide to attempt to replace this traffic, we may be required to increase our sales and marketing expenditures, including by utilizing paid search advertising. We are aware that certain of our competitors have spent additional funds to promote their products in search results over us. If we decide to respond by purchasing search advertising, our pet acquisition costs would increase and harm our business, operating results and financial condition.

If we are unable to grow our member base and maintain high member retention rates, our growth prospects and revenue will be adversely affected.

Our ability to grow our business depends on retaining and expanding our member base. For the year ended December 31, 2019, we generated 83.7% of our revenue from subscriptions. In order to continue to increase our membership, we must continue to convince prospective members of the benefits of pet insurance and existing members of the continuing value of our product.

We utilize Territory Partners, who are paid fees based on enrollments in their regions, to communicate the benefits of medical insurance to veterinarians through in-person visits. Veterinarians then educate pet owners, who visit our website or call our contact center to learn more about these benefits, and potentially become members. We also invest in other third-party and direct to consumer member acquisition channels, though we have limited experience with some of them. We plan to expand the number of our Territory Partners and other lead-generation sources and to engage in other marketing activities, including direct to consumer advertising, which are likely to increase our acquisition costs.

We seek to convert consumers who visit our website and call our contact center into members. The rate at which we convert these visitors into members is a significant factor in the growth of our member base. A number of factors have influenced, and could in the future influence, the conversion rates for any given period, some of which are outside of our control. These factors include:

- the competitiveness of our subscription, including its perceived value, simplicity, and fairness;
- changes in consumer shopping behaviors due to circumstances outside of our control, such as economic conditions and consumers' ability or willingness to pay for our product;
- regulatory requirements, including those that make the experience on our website cumbersome or difficult to navigate or that hinder our ability to speak with potential members quickly and in a way that is conducive to conversion;
- system failures or interruptions in our website or contact center; and
- changes in the mix of consumers who learn about us through various member acquisition channels.

We have made and plan to continue to make substantial investments in features and functionality for our website and training and staffing for our contact center that are designed to generate traffic, increase member engagement and improve member service. These activities do not directly generate revenue, however, and we may never realize any benefit from these investments. If the expenses that we incur in connection with these activities do not result in sufficient growth in members to offset the cost, our business, operating results and financial condition will be adversely affected.

We have historically experienced high average monthly retention rates. For example, our average monthly retention rate between 2010 and 2019 was 98.5%. We expect to continue to make significant expenditures relating to the retention of existing members, including an increase in the number of inside account managers and development and implementation of new technology platforms designed to encourage retention of these members.

If we do not retain our existing members or if our marketing initiatives do not result in enrolling more pets or result in enrolling pets that inherently have a lower retention rate, we may not be able to maintain our retention and new member acquisition rates. Members we obtain through aggressive promotions or other channels that involve relatively less meaningful contact between us and the member are more likely to terminate their subscription. In the past, we have experienced reduced retention rates during periods of rapid member growth, as our retention rate generally has been lower during the first year of member enrollment. Members may choose to terminate their subscription for a variety of reasons, including perceived or actual lack of value, delays or other unsatisfactory experiences in how we review and process veterinary invoice payments, unsatisfactory member service, an economic downturn, increased subscription fees, loss of a pet, a more attractive offer from a competitor, changes in our subscription or other reasons, including reasons that are outside of our control. Our cost of acquiring a new member is substantially greater than the cost involved in maintaining our relationship with an existing member. If we are not able to successfully retain existing members and limit terminations, our revenue and operating margins will be adversely impacted and our business, operating results and financial condition would be harmed.

We rely significantly on Territory Partners, veterinarians and other third parties, including strategic partners, to generate leads.

In order for us to implement our business strategy and grow our revenue, we must effectively maintain and increase the number and quality of our relationships with Territory Partners, veterinarians, existing members, online and other businesses, animal shelters, breeders and veterinary affiliates, including veterinarian purchasing groups and associations and other referral sources, and continue to scale and improve our processes, programs and procedures that support them. Those processes, programs and procedures could become increasingly complex and difficult to manage as we grow.

Veterinary leads represent our largest member acquisition channel. We spend significant time and resources attracting qualified Territory Partners and providing them with current information about our business and they, in turn, communicate the benefits of medical insurance for pets to veterinarians. Our relationship with our Territory Partners may be terminated at any time (for instance, if they feel unsupported or undervalued by us), and, if terminated, we may not recoup the costs associated with educating them about our subscription or be able to maintain any relationships they may have developed with veterinarians within their territories. Sometimes a single relationship may be used to cover multiple territories so that a terminated relationship could significantly affect our company. Further, if we experience an increase in the rate at which Territory Partner relationships are terminated, we may not develop or maintain relationships with veterinarians as quickly as we have in the past or need to in order to implement our business strategy and our growth and financial performance could be adversely affected.

Our ability to generate leads through veterinary hospitals could be negatively impacted if our policy is perceived to be inadequate, unreliable, cumbersome or otherwise does not provide sufficient value, or if our process for paying veterinary invoices is unsatisfactory to the veterinarians' clients.

If we fail to establish or are unable to maintain our existing member acquisition channels and/or continue to add new member acquisition channels, if the cost of our existing sources increases or does not scale as we anticipate, or if we are unable to continue to use any existing channels or programs in any jurisdiction, including our exam day offer program, our member levels and sales and marketing expenses may be adversely affected.

Territory Partners are independent contractors and, as such, may pose additional risks to our business.

Territory Partners are independent contractors and, accordingly, we do not directly provide the same direction, motivation and oversight over Territory Partners as we otherwise could if Territory Partners were our own employees. Further, Territory Partners may themselves employ or engage others; we refer to these partners and their associates, collectively, as our Territory Partners. We do not control a Territory Partner's employment or engagement of others, and it is possible that the actions of their employees and/or contractors could create threatened or actual legal proceedings against us.

Territory Partners may decide not to participate in our marketing initiatives and/or training opportunities, accept our introduction of new solutions or comply with our policies and procedures applicable to them, any of which may adversely affect our ability to develop relationships with veterinarians and grow our membership. Our sole recourse against Territory Partners who fail to perform is to terminate their contract, which could also trigger contractually obligated termination payments or result in disputes, including threatened or actual legal or regulatory proceedings.

We believe that Territory Partners are not and should not be classified as employees under existing interpretations of the applicable laws of the jurisdictions in which we operate. We do not pay or withhold any employment tax with respect to or on behalf of Territory Partners or extend any benefits to them that we generally extend to our employees, and we otherwise treat Territory Partners as independent contractors. Applicable authorities or the Territory Partners have in the past questioned and may in the future challenge this classification. Further, the applicable laws or regulations, including tax laws or interpretations, may change. If it were determined that we had misclassified any of our Territory Partners, we may be subjected to penalties and/or be required to pay withholding taxes, extend employee benefits, provide compensation for unpaid overtime, or otherwise incur substantially greater expenses with respect to Territory Partners. In addition, the costs associated with defending, settling, or resolving pending and future lawsuits (including demands for arbitration) relating to the independent contractor status of Territory Partners could be material to our business.

Any of the foregoing circumstances could have a material adverse impact on our operating results and financial condition.

The prices of our subscriptions are based on assumptions and estimates. If our actual experience differs from the assumptions and estimates used in pricing our subscriptions or if we are unable to obtain any necessary regulatory approval for our pricing, our revenue and financial condition could be adversely affected.

The pricing of our subscriptions reflects amounts we expect to pay for a pet's medical care and we derive these prices from assumptions that we make based on our analytics platform. Our analytics platform draws upon pet data we collect and we use this data to price our policy in response to a number of factors, including a pet's species, breed, age, gender and location. Factors related to pet location include the current and assumed changes in the cost and availability of veterinary technology and treatments and local veterinary hospital preferences. The assumptions we make about breeds and other factors in pricing may prove to be inaccurate and, accordingly, these pricing analytics may not accurately reflect the expense that we will ultimately incur. Furthermore, if any of our competitors develop similar or better data systems, adopt similar or better underwriting criteria and pricing models or receive our data, our competitive advantage could decline or be lost.

The prices of our subscriptions also reflect assumptions and estimates regarding our own operating costs and expenses. We monitor and manage our pricing and overall sales mix to achieve our target returns. If the actual costs, including veterinary invoice expenses, operating costs and expenses within anticipated pricing allowances, are greater than our assumptions and estimates such that the premiums we collect are insufficient to cover these expenses, then our gross profit could be adversely affected and our revenue may be insufficient to maintain profitability. Conversely, if our pricing assumptions differ from actual results such that we overprice risks, our competitiveness and growth prospects could be adversely affected.

In addition, many states have adopted laws or are considering proposed legislation that, among other things, limit the ability of insurance companies to effect rate increases or to cancel, reduce or not renew existing policies, and many state regulators have the power to reduce, or to disallow increases in premium rates. Most states require licensure and regulatory approval prior to marketing new insurance products. Our practice has been to regularly reevaluate the price of our subscriptions, with any pricing changes implemented at least annually, subject to the review and approval of the state regulators, who may reduce or disallow our pricing changes. Such review has often in the past resulted, and may in the future result, in delayed implementation of pricing changes and prevent us from making changes we believe are necessary to achieve our targeted payout ratio, which could adversely affect our operating results and financial condition. In addition, we may be prevented by regulators from limiting significant pricing changes, requiring us to raise rates more quickly than we otherwise may desire. This could damage our reputation with our members and reduce our retention rates, which could significantly damage our brand, result in the loss of expected revenue and otherwise harm our business, operating results and financial condition.

Our actual veterinary invoice expense may exceed our current reserve established for veterinary invoices and may adversely affect our operating results and financial condition.

Our recorded reserve for veterinary invoices is based on our best estimates of the amount of veterinary invoices we expect to pay, inclusive of an estimate for veterinary invoices we have not yet received, after considering internal factors, including data from our proprietary data analytics platform, experience with similar cases, actual veterinary invoices paid, historical trends involving veterinary invoice payment patterns, patterns of receipt of veterinary invoices, seasonality, pending levels of unpaid veterinary invoices, veterinary invoice processing programs and contractual terms. We may also consider external factors, including changes in the law, court decisions, changes to regulatory requirements and economic conditions. Because reserves are estimates of veterinary invoices that have been incurred but are not yet submitted to us, setting appropriate reserves is an inherently uncertain and complex process that involves significant subjective judgment. Further, we do not transfer or cede our risk as an insurer and, therefore, we maintain more risk than we would if we purchased reinsurance.

Rising costs of veterinary care and the increasing availability and usage of more expensive, technologically advanced medical treatments may increase the amounts of veterinary invoices we receive. Increases in the number of veterinary invoices we receive could arise from unexpected events that are inherently difficult to predict, such as a pandemic that spreads through the pet population, tainted pet food or supplies or an unusually high number of serious injuries or illnesses. We may experience volatility in the number of veterinary invoices we receive from time to time, and short-term trends may not continue over the longer term. The number of veterinary invoices may be affected by the level of care and attentiveness an owner provides to the pet, the pet's breed and age (at enrollment) and other factors outside of our control, as well as fluctuations in member retention rates and by new member initiatives that encourage an increase in veterinary invoices and other new member acquisition activities.

The ultimate cost of paying veterinary invoices and the related administration may vary materially from recorded reserves, and such variance may result in adjustments to the reserve for veterinary invoices, which could have a material effect on our operating results and resources available for acquiring additional members.

As more veterinary hospitals install and use our patented proprietary software, the number or amounts of veterinary invoices we receive is likely to increase.

Our patented proprietary software is designed to integrate directly with most software systems used by veterinary hospitals and allow us to receive and pay veterinarian invoices directly. We believe that it is critical to our long-term success to improve the member experience so we encourage veterinary hospitals to install and use our software. We have found that installation and use of our software by a veterinary hospital could increase the number of invoices we receive from that practice. As more veterinary hospitals install our software, we expect the number or amounts of veterinary invoices to increase and result in an increase in our cost of revenue and this may have a material adverse effect on our financial condition.

Our use of capital may be constrained by risk-based capital regulations or contractual obligations.

Our subsidiary, APIC, is subject to risk-based capital regulations that require us to maintain certain levels of surplus to support our overall business operations in consideration of our size and risk profile. We have in the past and may in the future fail to maintain the amount of risk-based capital required to avoid additional regulatory oversight, which was \$55.3 million as of December 31, 2019. We are also subject to a contractual obligation related to our reinsurance agreement with Omega, who writes our policies in Canada. Under this agreement, we are required to fund a Canadian trust account in accordance with Canadian regulations. As of December 31, 2019, the account held CAD \$4.3 million.

To comply with these regulations and contractual obligations, we may be required to maintain capital that we would otherwise invest in our growth and operations, which may require us to modify our operating plan or marketing initiatives, delay the implementation of new solutions or development of new technologies, decrease the rate at which we hire additional personnel and enter into relationships with Territory Partners, incur indebtedness or pursue equity or debt financings or otherwise modify our business operations, any of which could have a material adverse effect on our operating results and financial condition.

Our success depends on our ability to review, process, and pay veterinary invoices timely and accurately.

We believe member satisfaction depends on our ability to accurately evaluate and pay veterinary invoices in a timely manner. Many factors can affect our ability to do this, including the training, experience and skill of our personnel, our ability to reduce the number of payment requests made for services not included in our subscription, effectiveness of management, our ability to develop or select and implement appropriate procedures, supporting technologies and systems, changes in our policy and veterinarian compliance with our protocols and procedures. Our failure to pay veterinary invoices, accurately and in a timely manner, or to deploy resources appropriately, could result in unanticipated costs to us, lead to material litigation, undermine member goodwill and our reputation, and impair our brand image and, as a result, materially and adversely affect our competitiveness, financial results, prospects and liquidity.

We may not identify fraudulent or improperly inflated veterinary invoices.

It is possible that a member, or a third-party could submit a veterinary invoice which we would then pay that appears authentic but in fact does not reflect services provided or products purchased for which the member paid. It is also possible that veterinarians will charge insured customers higher amounts than they would charge their non-insured clients for the same service or product. Such activity could lead to unanticipated costs to us and/or to time and expense to recover such costs. They could also lead to strained relationships with veterinarians and/or members, and could adversely affect our competitiveness, financial results and liquidity.

We are and will continue to be faced with many competitive challenges, any of which could adversely affect our prospects, operating results and financial condition.

We compete with pet owners that self-finance unexpected veterinary invoices with savings or credit, as well as traditional “pet insurance” providers and relatively new entrants into our market. The vast majority of pet owners in the United States and Canada do not currently have medical insurance for their pets. We are focused primarily on expanding our share of the overall market, and we view our primary competitive challenge as educating pet owners on why our subscription is a better alternative to self-financing.

Additionally, there are traditional insurance companies that provide pet insurance products, either as a stand-alone product or along with a broad range of other insurance products, such as wellness. In addition, new entrants backed by large insurance companies, such as Marsh, Nationwide, and Geico, have attempted to enter the pet insurance market in the past and may do so again in the future. Further, traditional “pet insurance” providers may consolidate or take other actions to mimic the efficiencies from our vertically-integrated structure or create other operational efficiencies, which could lead to increased competition.

Some of our current and potential competitors have longer operating histories, larger customer bases, greater brand recognition and significantly greater financial, technical, marketing and other resources than we do. Some of our competitors may be able to undertake more extensive marketing initiatives for their brands and services, devote more resources to website and systems development and make offers that are more attractive to potential employees, referral sources and third-party service providers.

To compete effectively, we believe we will need to continue to invest significant resources in sales and marketing, in improving our member service levels, in the online experience and functionalities of our website and in other technologies and infrastructure. Failure to compete effectively against our current or future competitors could result in loss of current or potential members, which could adversely affect our pricing, lower our revenue, prevent us from maintaining profitability and diminish our brand strength.

If we are unable to maintain and enhance our brand recognition and reputation, our business and operating results will be harmed.

We believe that maintaining and enhancing our brand recognition and reputation is critical to our relationships with existing members, Territory Partners, veterinarians and others, and to our ability to attract new members, new Territory Partners, and additional supportive veterinarians. We also believe that the importance of our brand recognition and reputation will continue to increase as competition in our market continues to develop and mature. Our success in this area will depend on a wide range of factors, some of which are out of our control, including the following:

- the efficacy and viability of our sales and marketing programs;
- the perceived value of our subscription;
- the quality of service provided, including the fairness, ease and timeliness of reviewing and paying veterinary invoices;
- actions of our competitors, Territory Partners, veterinarians and others;
- positive or negative publicity, including regulatory pronouncements and material on the Internet or social media;
- regulatory and other government-related developments; and
- litigation-related developments.

The promotion of our brand will require us to make substantial investments, and we anticipate that, as our market becomes increasingly competitive, these branding initiatives may become increasingly difficult and expensive. For instance, we have found that search engine optimization costs have increased as competitors have spent additional funds to promote their products in search results over us. Our brand promotion activities may not be successful or yield increased revenue, and to the extent that these activities result in increased revenue, the increased revenue may not offset the expenses we incur and our operating results could be harmed. If we do not successfully maintain and enhance our brand, our business may not grow and could be adversely affected, which would harm our business, operating results and financial condition.

Furthermore, negative publicity, whether or not justified, relating to events or activities attributed to us, our employees, our strategic partners, our affiliates, or others associated with any of these parties, may tarnish our reputation and reduce the value of our brands. Damage to our reputation and loss of brand equity may reduce demand for our services and have an adverse effect on our business, operating results, and financial condition. Moreover, any attempts to rebuild our reputation and restore the value of our brands may be costly and time consuming, and such efforts may not ultimately be successful.

Our business depends on our ability to maintain and scale the infrastructure necessary to operate our technology platform and could be adversely affected by a system failure.

Our business depends on our ability to maintain and scale the infrastructure necessary to operate our technology platform, which includes our analytics and pricing engine, systems for managing veterinary invoice payments, customer relationship management system, billing system, contact center phone system and website. We use these technology frameworks to price our subscriptions, enroll members, engage with current members and pay veterinary invoices. Our members review and purchase subscriptions through our website and contact center, and for those veterinary hospitals who have installed our patented proprietary software, we receive and pay veterinarian invoices directly through our software. Our reputation and ability to acquire, retain and serve our members depends on the reliable performance of our technology platform and the underlying network systems and infrastructure, and on providing best-in-class member service, including through our contact center and website. As our member base continues to grow, the amount of information collected and stored on the systems and infrastructure supporting our technology platform will continue to grow, and we expect to require an increasing amount of network capacity, computing power and information technology personnel to develop and maintain our technology platform and service our departments involved in member interaction.

We have made, and expect to continue to make, substantial investments in equipment and related network infrastructure to handle the operational demands on our technology platform, including increasing data collection, software development, traffic on our website and the volume of calls at our contact center. The operation of the systems and infrastructure supporting our technology platform is expensive and complex and could experience operational failures. In the event that our data collection, member base or amount of traffic on these systems grows more quickly than anticipated, we may be required to incur significant additional costs to increase the capacity in our systems. Further, our development and implementation activities may not be successful, may not be well-received by veterinarians or by new or existing members, particularly if they are costly, cumbersome or unreliable, and we may incur delays or cost overruns or elect to curtail our currently planned expenditures related to them. Even if our system improvements are well-received, they may be or become obsolete due to technological reasons or the availability of alternative solutions in the marketplace. If new solutions and enhancements are not successful on a long-term basis, we may not realize benefits from these investments, and our business and financial condition could be adversely affected.

In addition, any system failure that causes an interruption in or decreases the responsiveness of our services could impair our revenue-generating capabilities, harm our business and operating results and damage our reputation. In addition, any loss or mishandling of data could result in breach of confidence, competitive disadvantage or loss of members, and subject us to potential liability. Any failure of the systems and infrastructure that we rely on could negatively impact our enrollments as well as our relationship with members. If we do not maintain or expand the systems and infrastructure underlying our technology platform successfully, or if we experience operational failures, our reputation could be harmed and we could lose current and potential members, which could harm our operating results and financial condition.

If we fail to effectively manage our growth, our business, operating results and financial condition may suffer.

We have recently experienced, and expect to continue to experience, significant growth, which has placed, and may continue to place, significant demands on our management and our operational and financial systems and infrastructure. We expect that our growth strategy will require us to commit substantial financial, operational and technical resources and this commitment may also result in increased costs (such as member acquisition costs or costs associated with increases in the number or amounts of veterinary invoices received) generated by our business, which could prevent us from remaining profitable and could impair our ability to compete effectively for business. If we do not effectively manage growth at any time, our financial condition could be harmed and the quality of our services could suffer.

In order to successfully expand our business, we need to hire, integrate and retain highly skilled and motivated employees and continue to improve our existing systems for operational and financial management. These improvements could require significant capital expenditures and place increasing demands on our management. If we do not successfully implement improvements in these areas, our business, operating results and financial condition will be harmed.

Emerging claim and coverage issues may adversely affect our business.

As industry practices and legal, judicial, social and other environmental conditions change, unexpected and unintended issues related to claims and coverage may emerge, including new or expanded theories of liability. These or other changes could impose new financial obligations on us by extending coverage beyond our underwriting intent or otherwise require us to make unplanned modifications to the products and services that we provide, or cause the delay or cancellation of products and services that we provide. In some instances, these changes may not become apparent until sometime after we have issued subscriptions that are affected by the changes. As a result, the full extent of liability under our subscriptions may not be known for many years after subscription begins.

Our operating results may vary, which could make period-to-period comparisons less meaningful, and make our future results difficult to predict.

We may experience fluctuations in our revenue, expenses and operating results in future periods. Our operating results may fluctuate in the future as a result of a number of factors, many of which are beyond our control. These fluctuations may make comparing our operating results on a period-to-period basis less meaningful and make our future results difficult to predict. You should not rely on our past results as an indication of our future performance. In addition, if revenue levels do not meet our expectations, our operating results and ability to execute on our business plan are likely to be harmed.

Seasonal or periodic variations in the behavior of our members also may cause fluctuations in our financial results. Enrollment in our subscription tends to be discretionary in nature and may be sporadic, reflecting overall economic conditions, budgeting constraints, pet-buying patterns and a variety of other factors, many of which are outside our control. For example, we have experienced some effects of seasonal trends in visits to veterinarians in the fourth quarter and in the beginning of the first quarter of each year in connection with the traditional holiday season. While we believe seasonal trends have affected and will continue to affect our quarterly results, our growth may have overshadowed these effects to date. We believe that our business will continue to be subject to seasonality in the future, which may result in fluctuations in our financial results.

Due to these and other factors, our financial results for any quarterly or annual period may not meet our expectations or the expectations of investors or analysts that follow our stock and may not be meaningful indications of our future performance.

Mergers or other strategic transactions involving our competitors could weaken our competitive position, which could adversely affect our ability to compete effectively and harm our results of operations.

Our industry is highly fragmented, and we believe it is likely that some of our existing competitors will consolidate or be acquired. In addition, some of our competitors may enter into new alliances with each other or may establish or strengthen cooperative relationships with systems integrators, third-party consulting firms or other parties. Any such consolidation, acquisition, alliance or cooperative relationship could adversely affect our ability to compete effectively and lead to pricing pressure and our loss of market share and could result in a competitor with greater financial, technical, marketing, service and other resources, all of which could harm our business, financial condition, cash flows and results of operations.

We depend on key personnel to operate our business and, if we are unable to retain, attract and integrate qualified personnel, our ability to develop and successfully grow our business could be harmed.

Our success depends to a significant extent on the continued services of our current management team, including Darryl Rawlings, our founder and Chief Executive Officer. The loss of Mr. Rawlings or several other key executives or employees within a short time frame could have a material adverse effect on our business. We employ all of our executive officers and key employees on an at-will basis, and their employment can be terminated by us or them at any time, for any reason and without notice, subject, in certain cases, to severance payment rights. In order to retain valuable employees, in addition to salary and cash incentives, we have provided stock options and restricted stock that vest over time and may in the future grant equity awards tied to company performance. The value to employees of stock options and restricted stock that vest over time will be significantly affected by movements in our stock price that are beyond our control and may at any time be insufficient to maintain their retention benefit or counteract offers from other companies. We would be adversely affected if we fail to adequately plan for the succession of our senior management and other key employees. Additionally, if we were to lose a large percentage of our current employees in a relatively short time period, or our employees were to engage in a work stoppage or unionize, we may be unable to hire and train new employees quickly enough to prevent disruptions in our operations, which may result in the loss of members, Territory Partners or referral sources.

Our success also depends on our ability to attract, retain and motivate additional skilled management personnel. We plan to continue to expand our work force, which we believe will enhance our business and operating results. We believe that there is significant competition for qualified personnel with the skills and knowledge that we require. Many of the other companies with which we compete for qualified personnel have greater financial and other resources than we do. New hires require significant training and, in most cases, take significant time before they achieve full productivity. New employees may not become as productive as we expect, and we may be unable to hire or retain sufficient numbers of qualified individuals.

We have and may continue to create, invest in or acquire businesses, products and technologies, which could divert our management's attention, result in additional dilution to our stockholders, otherwise disrupt our operations or harm our operating results.

We have and may continue to create, invest in or acquire complementary businesses, products, technologies and new lines of business. Our ability to successfully evaluate and manage investment opportunities, or make and integrate acquisitions or products, is unproven. For example, we have invested in a pet food initiative, and we believe that pet food may be an important part of our offerings over the long term. We do not have experience manufacturing, selling, or distributing food products and pet food manufacturing facilities and pet food products are subject to many laws and regulations administered by the United States Department of Agriculture, the Federal Food and Drug Administration, the Occupational Safety and Health Administration, and other federal, state, local, and foreign governmental agencies relating to the production, packaging, labelling, storage, distribution, quality, and safety of food products and the health and safety of employees.

The pursuit of potential new products, investments or acquisitions may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable opportunities, whether or not they are consummated. Further, even if we successfully invest in or acquire additional businesses or technologies, we may not achieve the anticipated benefits from the transaction. The investment or acquisition may also expose us to additional risks, including from unknowingly inheriting liabilities that are not adequately covered by indemnities. Acquisitions or investments could also result in dilutive issuances of equity securities or the incurrence of debt, which could adversely affect our operating results.

If we do not spend our development budget efficiently or effectively on commercially successful and innovative offerings and products, we may not realize the expected benefits of our strategy. Further, our development efforts with respect to new products and offerings could distract management from current operations, and will divert capital and other resources from our more established products and offerings. If an investment or acquisition fails to meet our expectations, our business, operating results and financial condition may suffer.

We depend on relationships with strategic partners, and our inability to maintain our existing and secure new relationships with strategic partners could harm our revenue and operating results.

A portion of our revenue is attributable to a variety of different types of strategic partnership arrangements. These partnerships involve various risks, depending on their structure, including the following:

- we may be unable to maintain or secure favorable relationships with strategic partners;
- our strategic partners may not be successful in creating leads;
- we may be unable to convert leads from our strategic partners into enrolled pets;
- our strategic partners could terminate their relationships with us;
- our strategic partners may acquire or form alliances with our competitors, thereby reducing their business with us;
- we may not experience a consistent correlation between revenues and expenditures related to the partnership; and
- bad publicity and other issues faced by our strategic partners could negatively impact us.

Any inability to secure, maintain or effectively manage these complicated relationships with strategic partners could have a material adverse effect on our revenue and operating results.

Our business and financial condition is subject to risks related to our writing of policies unaffiliated third parties.

Our other business segment includes revenues and expenses involving contractual relationships with unaffiliated third parties and related marketing to enterprises. We have relatively limited experience in writing policies for unaffiliated third parties. This business is not expected to grow at the same rate as our core business and may decline. Changes to this business may be volatile due to the nature of the relationships. Further, this business historically has had, and we expect it to continue to have, lower margins than our core business. As a result of this line of business, we are subject to additional regulatory requirements and scrutiny, which increase our costs and risks, and may have an adverse effect on our operations. Further, administration of this business and any similar business in the future may divert our time and attention away from our core business, which could adversely affect our operating results in the aggregate.

For example, the pet insurance policies we write for general agents are subject to materially different terms and conditions than our subscription. They are typically annual policies with monthly payment terms, which can result in accounts receivable balances and payment timing patterns we do not experience in our subscription business. The relationships with these general agents may be terminated by either party and, if terminated, would result in a reduction in our revenue to the extent we cannot enter other relationships and generate equivalent revenue with different general agents. For the year ended December 31, 2019, premiums from policies sourced by general agents accounted for 14% of our total revenue, and one general agent sourced members whose premiums accounted for over 10% of our total revenue. Further, the unaffiliated general agents administer these policies and market them to consumers. If the general agents make operating decisions that adversely affect its business or brand, our business or brand could also be adversely affected.

In Canada, our medical plan is written by Omega General Insurance Company. If Omega were to terminate its underwriting arrangement with us, our business could be adversely affected.

In Canada, our pet insurance subscription is written by Omega, and we assume all premiums written by Omega and the related veterinary invoice expense through an agency agreement and a fronting and administration agreement. If Omega were to terminate our agreement or be unable to write insurance for regulatory or other reasons, we may have to terminate subscriptions with our existing Canadian members, or suspend member enrollment and renewals in Canada until we enter into a relationship with another third party to write our subscription or we set up an entity able to perform this service, which may take a significant amount of time and require significant expense. We may not be able to enter into a new relationship, and any new relationship would likely be on less favorable terms. Any delay in entry into a new relationship or suspension of member enrollment and renewals could have a material adverse effect on our operating results and financial condition.

Changes in the foreign exchange rates may adversely affect our revenue and operating results.

We offer our subscription in Canada and in the future may offer it in other countries, which exposes us to the risk of changes in currency exchange rates. For the year ended December 31, 2019, approximately 18% of our total revenue was generated in Canada. Fluctuations in the relative strength of the US dollar has in the past and could in the future adversely affect our revenue and operating results.

We may decide to set up multiple insurance subsidiaries, which may complicate our business and harm our results of operations.

Currently, APIC, our wholly owned subsidiary, underwrites memberships for our U.S. subscription product, and Omega, a third party, underwrites memberships for our Canadian subscription product. We are in the process of setting up additional wholly owned insurance companies in the U.S. and Canada to underwrite our subscription and in the future we may decide to set up and operate additional wholly-owned insurance companies in the U.S., Canada or a different country. The pursuit of acquiring or forming a new insurance subsidiary may divert the attention of management and cause us to incur various expenses in identifying, investigating and pursuing suitable opportunities, whether or not the formation or acquisition is completed. Further, even if we are successful in forming or acquiring a new insurance subsidiary we may not achieve the anticipated benefits. In addition, we may require additional capital to meet our risk-based capital requirements for the new insurance subsidiaries and will be subject to additional regulatory scrutiny in the jurisdiction of incorporation and any additional jurisdictions the insurance subsidiary operates. Failure to comply with laws, regulations and guidelines applicable to a new insurance subsidiary could result in significant liability, result in the loss of revenue and otherwise harm our business, operating results and financial condition.

If we are unable to implement and maintain effective internal control over financial reporting in the future, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock may be negatively affected.

Section 404 of the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act) requires that we evaluate and determine the effectiveness of our internal control over financial reporting and provide a management report on the internal control over financial reporting, which must be attested to by our independent registered public accounting firm.

We may not detect errors on a timely basis and our financial statements may be materially misstated. We have had in the past, and may have in the future, material weaknesses and significant deficiencies in our internal control over financial reporting. If we or our independent registered public accounting firm identify future material weaknesses in our internal control over financial reporting, we are unable to comply with the requirements of Section 404 in a timely manner, we are unable to assert that our internal control over financial reporting is effective or our independent registered public accounting firm is unable to express an opinion as to the effectiveness of our internal control over financial reporting, investors may lose confidence in the accuracy and completeness of our financial reports and the market price of our common stock could be negatively affected. We could also become subject to investigations by the stock exchange on which our securities are listed, the SEC or other regulatory authorities, which could require additional financial and management resources.

If our security measures are breached and unauthorized access is obtained to our data, including our members' data, we may lose our competitive advantage, our systems may be perceived as not being secure and we may incur third-party liability.

Our data repository contains proprietary information that we believe gives us a competitive advantage, including data on veterinary invoices received and other data with respect to members, Territory Partners, veterinarians and other third parties. We also collect and utilize demographic and other information from and about our members when they visit our website, call our contact center and apply for enrollment. Further, we use tracking technologies, including "cookies," to help us manage and track our members' interactions and deliver relevant advice and advertising. Security breaches could expose us to a risk of loss of our data and/or disclosure of this data, either publicly or to a third party who could use the information to gain a competitive advantage. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or implement adequate preventative measures. In the event of a loss of our systems or data, we could experience increased costs, delays, legal liability and reputational harm, which in turn may harm our financial condition, damage our brand and result in the loss of members. Such a disclosure also could lead to litigation and possible liability.

In the course of operating our business, we store and/or transmit our members' confidential information, including credit card and bank account numbers and other private information. Because the methods used to obtain unauthorized access to private information change frequently and may be difficult to detect for long periods of time, security breaches would expose us to a risk of loss of this information, litigation and possible liability. Our payment services are similarly susceptible to credit card and other payment fraud schemes, including unauthorized use of credit cards, debit cards or bank account information, identity theft or merchant fraud.

If our security measures are breached as a result of third-party action, employee error, malfeasance or otherwise, and, as a result, someone obtains unauthorized access to our data, including data of our members, our reputation may be damaged, our business may suffer and we could incur significant liability. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and generally are not recognized until launched against a target, we may be unable to anticipate these techniques or implement adequate preventative measures. If an actual or perceived breach of our security occurs, the public perception of the effectiveness of our security measures could be harmed.

In addition, cyber-attacks or acts of terrorism could cause disruptions in our business or the economy as a whole. Our servers and systems may also be vulnerable to computer viruses, break-ins and similar disruptions from unauthorized tampering with our computer systems, which could lead to interruptions, delays, loss of critical data or the unauthorized disclosure of confidential member data. We currently have limited disaster recovery capability, and our business interruption insurance may be insufficient to compensate us for losses that may occur. Such disruptions could negatively impact our ability to run our business, which could have an adverse effect on our operating results and financial condition.

We are subject to a number of risks related to accepting automatic fund transfers and credit card and debit card payments.

We accept payments of subscription fees from our members through automatic fund transfers and credit and debit card transactions. For credit and debit card payments, we pay interchange and other fees, which may increase over time. An increase in the number of members who utilize credit and debit cards to pay their subscription fees or related credit and debit card fees would reduce our margins and could require us to increase subscription fees, which could cause us to lose members and revenue, or suffer an increase in our operating expenses, either of which could adversely affect our operating results.

If we, or any of our processing vendors or banks have problems with our billing software, or if the billing software malfunctions, it could have an adverse effect on our member satisfaction and could cause one or more of the major credit card companies or banks to disallow our continued use of their payment products. In addition, if our billing software fails to work properly and, as a result, we do not automatically charge our members' credit cards on a timely basis or at all, or a bank withdraws the incorrect amount or fails to timely transfer the correct amount to us, we could lose revenue and harm our member experience, which could adversely affect our business and operating results. Moreover, a vendor could fail to process payments, or could process payments in the wrong amounts, which could result in us failing to collect premiums, could result in increased cancellations and could adversely affect our reputation.

We are also subject to payment card association operating rules, certification requirements and rules governing electronic funds transfers, including the Payment Card Industry Data Security Standard (PCI DSS), a security standard applicable to companies that collect, store or transmit certain data regarding credit and debit cards, holders and transactions. Although we are currently compliant with PCI DSS, in the past we were not, and in the future we may not be, fully or materially compliant with PCI DSS, or other payment card operating rules. Any failure to comply with the PCI DSS in the future may violate payment card association operating rules, federal and state laws and regulations, and the terms of our contracts with payment processors and merchant banks. Such failure to comply may subject us to fines, penalties, damages and civil liability, and may result in the loss of our ability to accept credit and debit card payments. In addition, there is no guarantee that PCI DSS compliance will prevent illegal or improper use of our payment systems or the theft, loss or misuse of data pertaining to credit and debit cards, credit and debit card holders and credit and debit card transactions.

If we fail to adequately control fraudulent credit card transactions, we may face civil liability, diminished public perception of our security measures and significantly higher credit card-related costs, each of which could adversely affect our business, operating results and financial condition.

If we are unable to maintain our chargeback rate at acceptable levels, our credit card fees for chargeback transactions, or our fees for many or all categories of credit and debit card transactions, credit card companies and debit card issuers may increase our fees or terminate their relationship with us. Any increases in our credit card and debit card fees could adversely affect our operating results, particularly if we elect not to raise our subscription fees. The termination of our ability to process payments on any major credit or debit card would significantly impair our ability to operate our business.

We have limited experience owning an office building and may face unexpected costs.

In August 2018, we purchased our home office building. Prior to this purchase, we had no experience owning an office building. It is difficult to predict all costs associated with maintaining the building and ensuring it is suitable for our use and that of other tenants and maintain compliance with all environmental and other regulations applicable to ownership of real estate. It is possible that the other current tenants in the building may cease to rent space in the building, which would decrease rental income we expect to receive from them. We recently learned that one tenant has decided not to continue leasing space in the building and we are evaluating use of the newly vacant space. Tenants may also negotiate tenant improvements, requiring capital expenditures that may adversely impact our financial position. In addition, we may identify structural defects or other conditions, or we may determine that remodeling or renovations are necessary given our business operations and objectives. Managing tenants, maintaining the building, and otherwise facing the costs and responsibilities of being the owner of a building may be a distraction from our core business and cause our performance to suffer.

Failure to adequately protect our intellectual property could substantially harm our business and operating results.

We rely on a combination of intellectual property rights, including trade secrets, patents, copyrights, trademarks and domain names, as well as contractual restrictions, to establish and protect our patented proprietary software and our intellectual property. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy our digital content, pricing analytics, technology, software, branding and functionality, or obtain and use information that we consider proprietary. Moreover, policing our proprietary rights is difficult and may not always be effective. If we continue to expand internationally, we may need to enforce our rights under the laws of countries that do not protect proprietary rights to as great an extent as do the laws of the United States, which may be expensive and divert management's attention away from other operations.

Our proprietary software is protected by patents. These patents may not be sufficient to maintain effective product exclusivity because patent rights are limited in time and do not always provide effective protection. Furthermore, our efforts to enforce or protect our patent rights may be ineffective, could result in substantial costs and diversion of resources, could result in the invalidation of our patent rights, and could substantially harm our operating results. Even where our patents rights are enforced, legal remedies available for harm caused to us by infringing products may be inadequate to make us whole. Further, our successful assertion of our patent against one competing product is not necessarily predictive of our future success or failure in asserting the same patent against a second competing product. In addition, patents have a limited lifespan. In the United States, the natural expiration of a patent is generally 20 years after it is filed. Various extensions may be available. However, the life of a patent, and the protection it affords, is limited. Once the patent life has expired for our software, our competitors will be able to use our patented technology.

We seek to control access to our proprietary technology, software and documentation by entering into confidentiality and invention assignment agreements with our employees and partners, confidentiality agreements or license agreements with third parties, such as service providers, vendors, individuals and entities that may be exploring a business relationship with us, and terms of use with third parties, such as veterinary hospitals desiring to use our technology, software and documentation. These agreements may not prevent disclosure of intellectual property, trade secrets and/or other confidential information, and may not provide an adequate remedy in the event of misappropriation of trade secrets or any unauthorized disclosure of trade secrets and other confidential information. In addition, others may independently discover trade secrets and confidential information and, in such cases, we may not be able to assert any trade secret rights against such parties. Costly and time-consuming litigation could be necessary to enforce and determine the scope of our intellectual property rights and related confidentiality, license and nondisclosure provisions, and failure to obtain or maintain trade secret protection, or our competitors being able to obtain our trade secrets or to independently develop technology similar to ours or competing technologies, could adversely affect our competitive business position.

Litigation or proceedings before the U.S. Patent and Trademark Office or other governmental authorities and administrative bodies in the United States and abroad may be necessary in the future to enforce our intellectual property rights, to protect our domain names and to determine the validity and scope of the proprietary rights of others. Our efforts to enforce or protect our proprietary rights may be ineffective, could result in substantial costs and diversion of resources and could substantially harm our operating results.

Assertions by third parties of infringement or other violation by us of their intellectual property rights could result in significant costs and substantially harm our business and operating results.

Third parties have in the past and may in the future claim that our services or technologies infringe or otherwise violate their intellectual property rights. We may be subject to legal proceedings and claims, including claims of alleged infringement by us of the intellectual property rights of third parties. Any dispute or litigation regarding intellectual property could be expensive and time consuming, regardless of the merits of any claim, and could divert our management and key personnel from our operations.

If we were to discover or be notified that our services potentially infringe or otherwise violate the intellectual property rights of others, we may need to obtain licenses from these parties in order to avoid infringement. We may not be able to obtain the necessary licenses on acceptable terms, or at all, and any such license may substantially restrict our use of the intellectual property. Moreover, if we are sued for infringement and lose the lawsuit, we could be required to pay substantial damages or be enjoined from offering the infringing services. Any of the foregoing could cause us to incur significant costs and prevent us from selling or properly administering subscriptions or performing under our other contractual relationships.

We rely on third parties to provide intellectual property and technology necessary for the operation of our business.

We utilize intellectual property and technology owned and/or hosted by third parties in developing and operating our technology platform and operating our business. From time to time, we may be required to renegotiate with these third parties or negotiate with other third parties to include or continue using their intellectual property or technology in our existing technology platform or business operations or in modifications or enhancements to our technology platform or business operations. We may not be able to obtain the necessary rights from these third parties on commercially reasonable terms, or at all, and the third-party intellectual property and technology we use or desire to use may not be appropriately supported, maintained or enhanced by the third parties. If we are unable to obtain the rights necessary to use or continue to use third-party intellectual property and technology in our operations, or if those third parties are unable to support, maintain and enhance their intellectual property and technology, we could experience increased costs or delays, which in turn may harm our financial condition, damage our brand and result in the loss of members.

Our technology platform and our data are also hosted by a third-party service provider. The terms under which such third-party service provider provides us services may change and we may be required to renegotiate with that third party. If we are unable to renegotiate satisfactory terms, we may not be able to transition to an alternative service provider without interrupting the availability of our technology platform and any interruption could materially and adversely affect our business. Additionally, if our third-party service provider experiences any disruptions, outages or catastrophes, or if it ceases to conduct business for any reason, we could experience an interruption in our business, which in turn may damage our brand, result in a loss of members and harm our financial condition.

The outcome of litigation or regulatory proceedings could subject us to significant monetary damages, restrict our ability to conduct our business, harm our reputation and otherwise negatively impact our business.

From time to time, we have been, and in the future may become, subject to litigation, claims and regulatory proceedings and inquiries, including market conduct examinations and investigations by state insurance regulatory agencies and threatened or filed lawsuits by, among others, government agencies, employees, competitors, current or former members, or business partners.

We cannot predict the outcome of these actions or proceedings, and the cost of defending such actions or proceedings could be material. Further, defending such actions or proceedings could divert our management and key personnel from our business operations. If we are found liable in any action or proceeding, we may have to pay substantial damages or fines, which may have a material adverse effect on our business, operating results, financial condition and prospects. More critically, an adverse result from a proceeding could require us to change the way we conduct our business, including our marketing and promotional practices, and such a result may have a greater adverse effect on our business than monetary damages or fines. There may also be negative publicity associated with litigation or regulatory proceedings that could harm our reputation or decrease acceptance of our services. These claims may be costly to defend and may result in assessment of damages, adverse tax consequences and harm to our reputation.

Covenants in the credit agreement governing our revolving line of credit may restrict our operations, and if we do not effectively manage our business to comply with these covenants, our financial condition could be adversely affected.

The credit agreement governing our revolving line of credit contains various restrictive covenants, including restrictions on our ability to dispose of our assets, merge with or acquire other entities, incur other indebtedness, make investments, and engage in transactions with our affiliates. Our credit agreement also contains certain financial covenants. Our ability to meet these restrictive covenants can be affected by events beyond our control. Our credit agreement provides that our breach or failure to satisfy certain covenants constitutes an event of default. Upon the occurrence of an event of default, our lenders could elect to declare any future amounts outstanding under our credit agreement to be immediately due and payable. If we are unable to repay those amounts, our financial condition could be adversely affected.

Any indebtedness we incur could adversely affect our business and limit our ability to expand our business or respond to changes, and we may be unable to generate sufficient cash flow to satisfy any of our debt service obligations.

As of December 31, 2019, we had \$26.2 million outstanding indebtedness under our revolving line of credit and may incur indebtedness in the future, including any additional borrowings available under our revolving line of credit. Any substantial indebtedness, and the fact that a substantial portion of our cash flow from operating activities could be needed to make payments on this indebtedness, could have adverse consequences, including the following:

- reducing the availability of our cash flow for our operations, capital expenditures, future business opportunities and other purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industries in which we operate, which could place us at a competitive disadvantage compared to our competitors that may have less debt;
- limiting our ability to borrow additional funds; and
- increasing our vulnerability to general adverse economic and industry conditions.

Our ability to borrow any funds needed to operate and expand our business will depend in part on our ability to generate cash. If our business does not generate sufficient cash flow from operating activities or if future borrowings, under our revolving credit facility or otherwise, are not available to us in amounts sufficient to enable us to fund our liquidity needs, our operating results, financial condition and ability to expand our business and meet our risk-based capital requirements may be adversely affected.

We may have additional tax liabilities.

We are subject to income tax, premium tax, transaction tax and other taxes in the U.S. and foreign jurisdictions. Judgment is required in determining our provision for income taxes, premium tax, transaction tax and other taxes. In the ordinary course of our business, there are many transactions and calculations where the ultimate tax determination is uncertain. Further, we often make elections for tax purposes which may ultimately not be upheld. Although we believe our tax estimates are reasonable, the final determination of tax audits and any related litigation in the jurisdictions where we are subject to taxation could be materially different from our historical income tax provisions and accruals. The results of an audit or litigation could have a material effect on our consolidated financial statements in the period or periods in which that determination is made.

Our ability to use our net operating loss carryforwards and certain other tax attributes may be limited.

As of December 31, 2019, we had U.S. federal net operating loss carryforwards of approximately \$130.3 million that will begin to expire in 2027. Under Sections 382 and 383 of the Internal Revenue Code of 1986, as amended (the Code), if a corporation undergoes an “ownership change,” the corporation’s ability to use its pre-change net operating loss carryforwards and other pre-change tax attributes, such as research tax credits, to offset its post-change income taxes may be limited. In general, an “ownership change” occurs if there is a cumulative change in our ownership by “5-percent stockholders” that exceeds 50 percentage points over a rolling three-year period. Similar rules may apply under state tax laws. Pursuant to Sections 382 and 383 of the Code, annual use of our net operating loss carryforwards and credit carryforwards may be limited by previous and future ownership changes.

Changes in the economy may negatively impact our business, operating results and financial condition.

Our business may be affected by changes in the economic environment. Medical insurance for cats and dogs is a discretionary purchase, and members may reduce or eliminate their discretionary spending during an economic downturn, resulting in an increase in terminations and a reduction in the number of new member enrollments. We may experience a material increase in terminations or a material reduction in our member retention rate in the future, especially in the event of a prolonged recessionary period or a downturn in economic conditions. Conversely, consumers may have more income to pay veterinary costs out-of-pocket and less desire to purchase our subscription during a period of economic growth. In addition, media prices may increase during a period of economic growth, which could increase our sales and marketing expenses. As a result, our business, operating results and financial condition may be significantly affected by changes in the economic environment.

We are expanding our operations internationally, and we may therefore become subject to a number of risks associated with international expansion and operations.

As part of our growth plan, we have explored, and expect to continue to explore, opportunities to expand our operations internationally. For instance, we recently entered the Australian market through a joint venture and we may enter other countries. We have no history of marketing, selling, administering and supporting our subscription for consumers outside of the United States, Canada, and Puerto Rico. In general, international sales and operations may be subject to a number of risks, including the following:

- regulatory rules and practices, foreign exchange controls, tariffs, tax laws and treaties that are different than those we operate under currently;
- the costs and resources required to modify our subscription appropriately to suit the needs and expectations of residents and veterinarians in such foreign countries;
- our data analytics platform may have limited applicability in foreign countries, which may impact our ability to develop adequate underwriting criteria and accurately price subscriptions in such countries;
- increased expenses incurred in establishing and maintaining office space and equipment for our international operations;
- technological incompatibility between our patented proprietary software and software used by veterinarians;
- difficulties in modifying our business model or subscription in a manner suitable for any particular foreign country, including any modifications to our Territory Partner model to the extent we determine that our existing model is not suitable for use in foreign countries;
- our lack of experience in marketing to consumers and veterinarians and online marketing in foreign countries;
- our relative lack of industry connections in many foreign countries;
- difficulties in managing operations due to language barriers, distance and time zone differences, staffing, cultural differences and business infrastructure constraints, including difficulty in obtaining foreign and domestic visas;
- the uncertainty of protection for intellectual property rights in some countries; and
- general economic and political conditions in these foreign markets.

These and other factors could harm our ability to gain future international revenue and, consequently, materially impact our business and operating results. The expansion of our existing international operations and entry into additional international markets will require significant management attention and financial resources, detracting from management attention and financial resources otherwise available to our existing business. Our failure to successfully manage our international operations and the associated risks effectively could limit the future growth of our business and could have an adverse effect on our operating results and financial condition.

Risks Related to Compliance with Laws and Regulations

We may not maintain the amount of risk-based capital required to avoid additional regulatory oversight, which may adversely affect our ability to operate our business.

Memberships in our U.S. subscription product are underwritten by APIC. APIC is an insurance company domiciled in the state of New York and licensed by the New York Department of Financial Services (NY DFS). Regulators in the states in which we do business impose risk-based capital requirements on APIC that generally are approved by the National Association of Insurance Commissioners (NAIC) to ensure APIC maintains reasonably appropriate levels of surplus to protect our members against adverse developments in APIC's financial circumstances, taking into account the risk characteristics of our assets, liabilities and certain other items. Generally, state insurance regulators will compare, on an annual basis as of December 31 or more often as deemed necessary, an insurer's total adjusted capital and surplus to assess an insurer's capital adequacy. If an insurer's risk-based capital falls below a specific threshold, the regulator may take action, which can range from directing an insurer to propose a plan to increase its capital to an acceptable level to placing the insurer under regulatory control.

Applicable regulations regarding risk-based capital may change, and/or the NY DFS may increase APIC's required levels of risk-based capital in the future. Regardless, we anticipate that we will need to maintain greater amounts of risk-based capital if our pet enrollment continues to grow. Additionally, a reduction in our risk-based capital may result in a breach of various contractual relationships, including, for example, with the unaffiliated general agents for which we write pet insurance policies, which may give such parties the ability to cancel their contracts with us and/or sue us for damages related to our risk-based capital levels, which could have a material adverse effect on our financial condition.

We may require additional capital to meet our risk-based capital requirements, pursue our business objectives and respond to business opportunities, challenges or unforeseen circumstances. If capital is not available to us at any time, our business, operating results and financial condition may be harmed.

We may require additional capital to meet our risk-based capital requirements, operate or expand our business or respond to unforeseen circumstances. Additional funds may not be available when we need them, on terms that are acceptable to us, or at all. If we raise additional funds through the issuance of equity or convertible securities, the percentage ownership of holders of our common stock could be significantly diluted and these newly issued securities may have rights, preferences or privileges senior to those of holders of our common stock. Further, volatility in the credit or equity markets may have an adverse effect on our ability to obtain debt or equity financing or the cost of such financing. Similarly, our access to funds may be impaired if regulatory authorities or rating agencies take negative actions against us. If a combination of these factors were to occur, our internal sources of liquidity may prove to be insufficient and, in such case, we may not be able to successfully obtain additional financing on favorable terms. If funds are unavailable to us on reasonable terms when we need them, we may be unable to meet our risk-based capital requirements, train and support our employees, support Territory Partners, maintain the competitiveness of our technology, pursue business opportunities, service our existing debt, pay veterinary invoices or acquire new members, any of which could have an adverse effect on our business, operating results and financial condition.

Our business is heavily regulated, and if we fail to comply with the numerous applicable laws and regulations our business and operating results could be harmed.

The sale of medical insurance for cats and dogs, which is considered a type of property and casualty insurance in most jurisdictions, is heavily regulated by federal, state, provincial and territorial governments in each jurisdiction in which we operate. In the United States, state insurance regulators are charged with protecting policyholders and have broad regulatory, supervisory and administrative powers over our business practices. Because we do business in all 50 states, the District of Columbia, all Canadian provinces and territories, and Puerto Rico, compliance with insurance-related laws, rules and regulations is difficult and imposes significant costs on our business. Each jurisdiction's insurance department typically has the power, among other things, to:

- grant and revoke licenses to transact insurance business;
- conduct inquiries into the insurance-related activities and conduct of agents and agencies and others in the sales, marketing and promotional channels;
- require and regulate disclosure in connection with the sale and solicitation of insurance policies;
- authorize how, by which personnel and under what circumstances insurance premiums can be quoted and published and an insurance policy sold;
- regulate how sales incentives may be structured;
- regulate the content of insurance-related advertisements, including web pages, and other marketing practices;
- approve policy forms, require specific benefits and benefit levels;
- regulate premium rates;
- impose fines and other penalties; and
- impose continuing education requirements.

While the U.S. federal government does not directly regulate the insurance industry, federal legislation and administrative policies can also affect us. Congress and various federal agencies periodically discuss proposals that would provide for federal oversight of insurance companies. We cannot predict whether any such laws will be enacted or the effect that such laws would have on our business. We also do business in all ten provinces and three territories of Canada. The provincial and territorial insurance regulators have the power to regulate the market conduct of insurers and insurance intermediaries, and the licensing and supervision of insurance agents, and brokers, along with enforcement rights, including the right to assess administrative monetary penalties in certain provinces.

Insurance companies are also regulated at the federal level in Canada, and the Insurance Companies Act prohibits a foreign entity from insuring risks in Canada unless it is authorized by an Order made by the Superintendent of Financial Institutions (Canada) permitting it to do so.

Due to the complexity, periodic modification and differing interpretations of insurance laws and regulations, we have not always been, and we may not always be, in compliance with them. A regulator's interpretation of existing laws or regulations may change without notice. Failure to comply with insurance laws, regulations and guidelines or other laws and regulations applicable to our business could result in significant liability, additional department of insurance licensing requirements, the revocation of licenses in a particular jurisdiction or our inability to sell subscriptions, which could significantly increase our operating expenses, result in the loss of our revenue and otherwise harm our business, operating results and financial condition.

Moreover, because adverse regulatory actions in one jurisdiction must be reported to other jurisdictions, an adverse regulatory action in one jurisdiction could result in penalties and adversely affect our license status or reputation in other jurisdictions. Even if the allegations in any regulatory or other action against us ultimately are determined to be unfounded, we could incur significant time and expense defending against the allegations, and any related negative publicity could harm consumer and third-party confidence in us, which could significantly damage our brand.

In addition, we have received, and may in the future receive, inquiries from regulators regarding our marketing and business practices. These inquiries may include investigations regarding a number of our business practices, including the manner in which we market and sell subscriptions, the manner in which we write policies for any unaffiliated general agent, and whether any amounts we pay to hospitals or hospital groups is appropriate. Any modification of our marketing or business practices in response to regulatory inquiries could harm our business, operating results or financial condition and lead to reputational harm.

States may adopt new laws that may adversely affect our operating results and financial condition.

The NAIC may draft model laws that focus on medical insurance for pets. States may enact new laws to adopt what the NAIC drafts, or a state may enact its own new laws or regulations that could affect our industry. Many states have and may continue to consider proposed legislation that could significantly affect our operations, including, for example, our ability to effect rate increases, to cancel or not issue existing policies, or how to market our product. Implementing changes in order to comply with new laws or regulations could also be time-consuming and costly.

We may not receive approval for changes to an existing product, for a proposed new product, for pricing changes, or we may not receive such approvals in a timely manner.

Most states require licensure and regulatory approval prior to marketing new insurance products or changing premiums for existing products. From time to time, we seek to make updates to our existing subscription product. We may also introduce new products that make changes that are more extensive to the product approved in a state. With respect to pricing, our practice has been to regularly reevaluate the price of our subscriptions, with any pricing changes implemented at least annually, subject to the review and approval of the state regulators, who may reduce or disallow our pricing changes. Such review has often in the past resulted, and may in the future result, in delayed implementation of pricing changes and prevent us from making changes we believe are necessary to achieve our targeted payout ratio, which could adversely affect our operating results and financial condition. A delayed approval may require us to raise rates more quickly than we otherwise may desire. This could damage our reputation with our members and reduce our retention rates, which could significantly damage our brand, result in the loss of expected revenue and otherwise harm our business, operating results and financial condition.

We may be affected by mandatory participation in plans that could result in contributions from insurance subsidiaries we own.

Certain states have enacted laws that require a property-casualty insurer, which includes a pet insurance company, conducting business in that state to participate in assigned risk plans, reinsurance facilities, joint underwriting associations (JUAs), Fair Access to Insurance Requirements (FAIR) plans and wind pools. In these markets, if the state reinsurance facilities, wind pools, FAIR plans or JUAs recognize a financial deficit, they may in turn have the ability to assess participating insurers, adversely affecting our operating results and financial condition if we are a part of such state reinsurance facilities, wind pools, FAIR plans or JUAs. Additionally, certain states require insurers to participate in guaranty funds for impaired or insolvent insurance companies. These funds periodically assess losses against all insurance companies doing business in the state. Our operating results and financial condition could be adversely affected by any of these factors.

Regulations that require individuals or entities that sell medical insurance for cats and dogs or process claims to be licensed may be interpreted to apply to our business more broadly than we expect them to, which could require us to modify our business practices, create liabilities, damage our reputation, and harm our business.

Insurance regulations generally require that each individual who sells, solicits or negotiates insurance on our behalf must maintain a valid license in the jurisdiction in which the activity occurs. Regulations also generally prohibit paying an insurance commission to an unlicensed person or entity. Regulations may also require certain individuals who process claims to be licensed. These requirements are subject to a variety of interpretations between jurisdictions. We may not interpret and apply the requirements in the same manner as all applicable regulators, and, even if we have, the requirements or regulatory interpretations of those requirements may change. Regulators have in the past and/or may in the future determine that certain of our personnel or third parties were performing licensable activities without the required license, including for example a veterinary hospital employee. If such persons were not in fact licensed in any such jurisdiction, we could become subject to conviction for an offense or the imposition of an administrative penalty, and liable for significant penalties. Regulators may also deem payments we make to an unlicensed entity or person to be improper. We would also likely be required to modify our business practices and/or sales and marketing programs, or license the affected individuals, which may be impractical or costly and time-consuming to implement. Any modification of our business or marketing practices in response to regulatory licensing requirements could harm our business, operating results or financial condition.

We are subject to numerous laws and regulations, and compliance with one law or regulation may result in non-compliance with another.

We are subject to numerous laws and regulations that are administered and enforced by a number of different governmental authorities, each of which exercises a degree of interpretive latitude, including, in the United States, state insurance regulators, state securities administrators, state attorneys general and federal agencies including the SEC, Internal Revenue Service and the U.S. Department of Justice. Consequently, we are subject to the risk that compliance with any particular regulator's or enforcement authority's interpretation of a legal issue may not result in compliance with another's interpretation of the same issue, particularly when compliance is judged in hindsight. In addition, there is risk that laws and regulations or any particular regulator's or enforcement authority's interpretation of a legal issue may change over time to our detriment, or that changes in the overall legal environment may, even absent any particular regulator's or enforcement authority's interpretation of a legal issue changing, cause us to change our views regarding the actions we need to take from a legal risk management perspective, thus necessitating changes to our practices that may, in some cases, increase our costs and limit our ability to grow or to improve the profitability of our business. Further, in some cases, these laws and regulations are designed to protect or benefit the interests of a specific constituency rather than a range of constituencies. For example, state insurance laws and regulations generally are intended to protect or benefit purchasers or users of insurance products, not holders of securities, which generally is the jurisdiction of the SEC. In many respects, these laws and regulations limit our ability to grow or to improve the profitability of our business.

Failure to comply with federal, state and provincial laws and regulations relating to privacy and security of personal information, and civil liabilities relating to breaches of privacy and security of personal information, could create liabilities for us, damage our reputation and harm our business.

A variety of U.S. and Canadian federal, state and provincial laws and regulations govern the collection, use, retention, sharing and security of personal information. Claims or allegations that we have violated applicable laws or regulations related to privacy and data security could in the future result in negative publicity and a loss of confidence in us by our members and our participating service providers, and may subject us to fines by credit card companies and the loss of our ability to accept credit and debit card payments. In addition, we have posted privacy policies and practices concerning the collection, use and disclosure of member data on our website. Several Internet companies have incurred penalties for failing to abide by the representations made in their privacy policies and practices. In addition, our use and retention of personal information could lead to civil liability exposure in the event of any disclosure of such information due to hacking, viruses, inadvertent action or other use or disclosure. Several companies have been subject to civil actions, including class actions, relating to this exposure.

We have incurred, and will continue to incur, expenses to comply with privacy and security standards and protocols for personal information imposed by law, regulation, self-regulatory bodies, industry standards and contractual obligations. Such laws, standards and regulations, however, are evolving and subject to potentially differing interpretations, and federal, state and provincial legislative and regulatory bodies may expand current or enact new laws or regulations regarding privacy matters. We are unable to predict what additional legislation, standards or regulation in the area of privacy and security of personal information could be enacted or its effect on our operations and business.

Law and regulations of the Internet, email and texting could adversely affect our business.

Many laws governing general commerce on the Internet remain unsettled and it may take years to fully determine whether and how existing laws such as those governing insurance, intellectual property, privacy and taxation apply to the Internet. In addition, the growth and development of the market for electronic commerce and Internet-related pet insurance advertisements and transactions may prompt calls for more stringent consumer protection laws that may impose additional burdens on companies conducting business and selling subscriptions over the Internet. Any new laws or regulations or new interpretations of existing laws or regulations relating to the Internet could harm our business and we could be forced to incur substantial costs in order to comply with them, which would harm our business, operating results and financial condition.

Additionally, we use phone solicitation, email and texting to market our services to potential members and/or as a means of communicating with our existing members. The laws and regulations governing the use of phone solicitation, email and texting continue to evolve, and the growth and development of the market for commerce over the Internet may lead to the adoption of additional legislation. Failure to comply with existing or new laws regarding phone solicitation, text or electronic communications with members could lead to significant damages. We have incurred, and will continue to incur, expenses in our efforts to comply with electronic messaging laws. If new laws or regulations are adopted, or existing laws and regulations are interpreted, to impose additional restrictions on our ability to send email to our members or potential members, we may not be able to communicate with them in a cost-effective manner. In addition to legal restrictions on the use of email for commercial purposes, Internet and email service providers and others attempt to block the transmission of unsolicited email, commonly known as “spam.” Many service providers have relationships with organizations whose purpose it is to detect and notify the Internet and email service providers of entities that the organization believes are sending unsolicited email. If an Internet or email service provider identifies messaging and email from us as “spam” as a result of reports from these organizations or otherwise, we could be placed on a restricted list that will block our emails to members or potential members. If we are restricted or unable to communicate by phone, text or email with our members and potential members as a result of legislation, blockage or otherwise, our business, operating results and financial condition would be harmed.

Applicable insurance laws regarding the change in control of our company may impede potential acquisitions that our stockholders might consider to be desirable.

We are subject to statutes and regulations of the state of New York that generally require that any person or entity desiring to acquire direct or indirect control of APIC obtain prior regulatory approval. These laws may discourage potential acquisition proposals and may delay, deter or prevent a change in control of our company, including through transactions, and in particular unsolicited transactions, that some of our stockholders might consider to be desirable. Similar laws or regulations may also apply in other states in which we may operate.

Our segregated account in Bermuda, WICL segregated account AX, could be adversely impacted by regulatory compliance of an unaffiliated third party.

Wyndham Insurance Company (SAC) Limited (WICL) is a class 3 insurer regulated by the Bermuda Monetary Authority (BMA). WICL’s ability to continue operations and pay dividends could impact the ability of our segregated account to do the same. WICL’s failure to meet regulatory requirements set forth by the BMA could result in our inability to transact business with WICL segregated account AX. Further, WICL could be limited from allowing dividends to be paid out of segregated account AX in the event of adverse regulatory actions.

Our accounting is becoming more complex, and relies upon estimates or judgments relating to our critical accounting policies. If our accounting is erroneous or based on assumptions that change or prove to be incorrect, our operating results could fall below the expectations of securities analysts and investors, resulting in a decline in our stock price.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes, and also to comply with many complex requirements and standards. We devote substantial resources to compliance with accounting requirements and we base our estimates on our best judgment, historical experience, information derived from third parties, and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets, liabilities, equity, revenue and expenses that are not readily apparent from other sources. However, various factors are causing our accounting to become complex, such as our recent building acquisition, our investments in strategic opportunities and our test expansion into foreign markets. Ongoing evolution of our business may compound these complexities. Our operating results may be adversely affected if we make accounting errors or our judgments prove to be wrong, assumptions change or actual circumstances differ from those in our assumptions, which could cause our operating results to fall below the expectations of securities analysts and investors or guidance we may have provided, resulting in a decline in our stock price and potential legal claims. Significant judgments, assumptions and estimates used in preparing our consolidated financial statements include those related to revenue recognition, stock-based compensation, business combinations, and income taxes.

Our reported financial results may be adversely affected by changes in accounting principles generally accepted in the United States.

Generally accepted accounting principles in the United States are subject to interpretation by the Financial Accounting Standards Board, the SEC and various bodies formed to promulgate and interpret appropriate accounting principles. A change in these principles or interpretations could have a significant effect on our reported financial results, could affect the reporting of transactions completed before the announcement of a change and could affect our compliance with financial debt covenants.

Risks Related to Ownership of Our Common Stock

Our actual operating results may differ significantly from our guidance.

From time to time we have released, and may continue to release, guidance in our quarterly earnings conference call, quarterly earnings releases, or otherwise, regarding our future performance that represents our management's estimates as of the date of release. This guidance, which includes forward-looking statements, has been and will be based on projections prepared by our management. These projections are not prepared with a view toward compliance with published guidelines of the American Institute of Certified Public Accountants, and neither our registered public accountants nor any other independent expert or outside party compiles or examines the projections. Accordingly, no such person expresses any opinion or any other form of assurance with respect to the projections.

Projections are based upon a number of assumptions and estimates that, while presented with numerical specificity, are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control and are based upon specific assumptions with respect to future business decisions, some of which will change. We intend to state possible outcomes as high and low ranges which are intended to provide a sensitivity analysis as variables are changed but are not intended to imply that actual results could not fall outside of the suggested ranges. The principal reason that we release guidance is to provide a basis for our management to discuss our business outlook with analysts and investors. We do not accept any responsibility for any projections or reports published by any such third parties.

Guidance is necessarily speculative in nature, and it can be expected that some or all of the assumptions underlying the guidance furnished by us will not materialize or will vary significantly from actual results. Accordingly, our guidance is only an estimate of what management believes is realizable as of the date of release. Actual results may vary from our guidance and the variations may be material. In light of the foregoing, investors are urged not to rely upon our guidance in making an investment decision regarding our common stock.

Any failure to successfully implement our operating strategy or the occurrence of any of the events or circumstances set forth in this report could result in the actual operating results being different from our guidance, and the differences may be adverse and material.

If securities or industry analysts do not publish research, or publish inaccurate or unfavorable research, about our business, our stock price and trading volume could decline.

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the securities or industry analysts who publish research about us or our business downgrade our stock or publish inaccurate or unfavorable evaluations of our company or our stock, the price of our stock could decline. If one or more of these analysts cease coverage of our company, our stock may lose visibility in the market, which in turn could cause our stock price to decline.

The market price of our common stock has been and is likely to continue to be volatile, and you may be unable to sell your shares at or above the price at which you purchased them.

The market price of our common stock has been and is likely to continue to fluctuate widely. Factors affecting the market price of our common stock include:

- variations in our operating results, earnings per share, cash flows from operating activities, and key operating metrics, and how those results compare to analyst expectations;
- forward-looking guidance that we provide to the public and industry and financial analysts related to future revenue and profitability, and any change in that guidance or our failure to achieve the results reflected in that guidance;
- the net increases in the number of members, either independently or as compared with published expectations of industry, financial or other analysts that cover our company;
- announcements of changes to our subscription, strategic alliances, acquisitions or significant agreements by us or by our competitors;
- recruitment or departure of key personnel;
- the economy as a whole and market conditions in our industry;
- trading activity by a limited number of stockholders who together beneficially own a majority of our outstanding common stock;
- the number of shares of our stock trading on a regular basis; and
- any other factors discussed in these risk factors.

In addition, if the market for stock in our industry or the stock market in general experiences uneven investor confidence, the market price of our common stock could decline for reasons unrelated to our business, operating results or financial condition. Some companies that have experienced volatility in the trading price of their stock have been the subject of securities class action litigation. If we are the subject of such litigation, it could result in substantial costs and a diversion of our management's attention and resources.

We do not intend to pay dividends on our common stock and, therefore, any returns will be limited to the value of our stock.

We have never declared or paid any cash dividends on our common stock. Other than potential repurchases of our common stock, we currently intend to retain all available funds and any future earnings for the development, operation and expansion of our business and do not anticipate declaring or paying any cash dividends for the foreseeable future. In addition, our ability to pay cash dividends on our common stock is limited by the terms of our credit agreement, APIC's ability to pay dividends is limited by New York state insurance laws, and WICL Segregated Account AX's ability to pay dividends is limited by our agreements with WICL as well as WICL's regulatory requirements. Any return to stockholders will therefore be limited to the increase, if any, of our stock price.

Our directors and principal stockholders own a significant percentage of our stock and will be able to exert significant control over matters subject to stockholder approval.

Our directors, five percent or greater stockholders and their respective affiliates beneficially hold a significant amount of our outstanding voting stock. Therefore, these stockholders have the ability to influence us through this ownership position. These stockholders may be able to determine all matters requiring stockholder approval. For example, these stockholders may be able to control elections of directors, amendments of our organizational documents, or approval of any merger, sale of assets, or other major corporate transaction. This may prevent or discourage unsolicited acquisition proposals or offers for our common stock that you or other stockholders may feel are in your or their best interest as one of our stockholders.

Provisions in our restated certificate of incorporation, restated bylaws and Delaware law might discourage, delay or prevent a change in control of our company or changes in our management and, therefore, depress the market price of our common stock.

Our restated certificate of incorporation and restated bylaws contain provisions that could depress the market price of our common stock by acting to discourage, delay or prevent a change in control of our company or changes in our management that the stockholders of our company may deem advantageous. These provisions, among other things:

- establish a classified board of directors so that not all members of our board are elected at one time;
- permit only the board of directors to establish the number of directors and fill vacancies on the board;
- provide that directors may only be removed "for cause" and only with the approval of two-thirds of our stockholders;
- require super-majority voting to amend some provisions in our restated certificate of incorporation and restated bylaws;
- authorize the issuance of "blank check" preferred stock that our board could use to implement a stockholder rights plan (also known as a "poison pill");
- eliminate the ability of our stockholders to call special meetings of stockholders;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- prohibit cumulative voting; and
- establish advance notice requirements for nominations for election to our board or for proposing matters that can be acted upon by stockholders at annual stockholder meetings.

In addition, Section 203 of the Delaware General Corporation Law may discourage, delay or prevent a change in control of our company. Section 203 imposes certain restrictions on mergers, business combinations and other transactions between us and holders of 15% or more of our common stock.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Our principal executive offices are located at 6100 4th Avenue South, Seattle, Washington. We purchased the building in August 2018 and occupy 91,437 square feet.

Item 3. Legal Proceedings

Information with respect to this item may be found in Note 8 of Item 8, "Financial Statements and Supplementary Data", under the caption, "Legal Proceedings" which information is incorporated herein by reference.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities

Market for our Common Stock

Our common stock began trading on the New York Stock Exchange (NYSE) under the symbol “TRUP” on July 18, 2014. Prior to that time, there was no public market for our common stock. On June 17, 2016, we voluntarily transferred the listing of our common stock from the NYSE to the NASDAQ Global Market of the NASDAQ Stock Market LLC (NASDAQ) where our common stock continues to be traded under the symbol “TRUP”.

Dividend Policy

We have never declared or paid cash dividends on our capital stock. We currently intend to retain any future earnings for use in the operation of our business and do not intend to declare or pay any cash dividends in the foreseeable future. Any further determination to pay dividends on our capital stock will be at the discretion of our board of directors, subject to applicable laws and restrictions in our outstanding credit agreement, and will depend on our financial condition, results of operations, capital requirements, general business conditions and other factors that our board of directors considers relevant.

Holders of Record

As of February 6, 2020, there were 44 stockholders of record of our common stock. The actual number of stockholders is greater than this number of record holders, and includes stockholders who are beneficial owners, whose shares are held of record by banks, brokers, and other financial institutions.

Securities Authorized for Issuance under Equity Compensation Plans

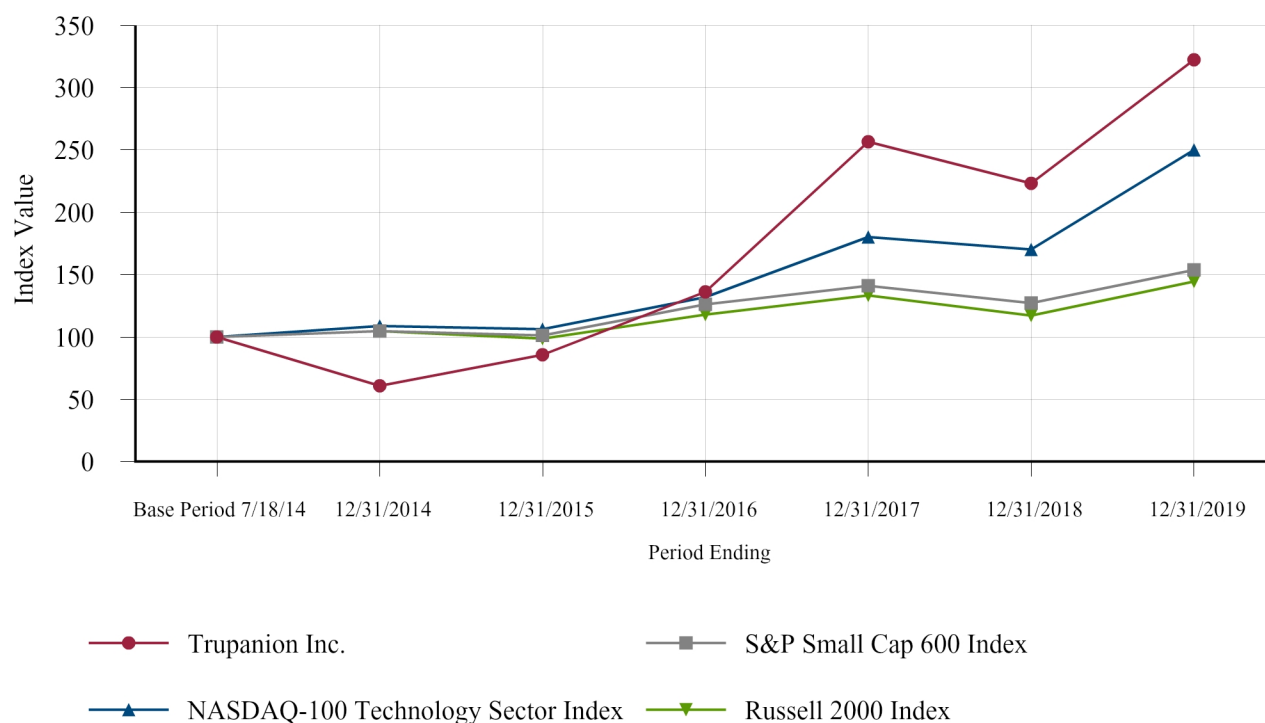
The information called for by this item is incorporated by reference to our Proxy Statement for the Annual Meeting of Stockholders to be held in 2020. See Part III, Item 12 “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.”

Stock Performance Graph

The following shall not be deemed “filed” for purposes of Section 18 of the Exchange Act, or incorporated by reference into any of our other filings under the Exchange Act or the Securities Act, except to the extent we specifically incorporate it by reference into such filing.

This chart compares the stockholder return on an investment of \$100 over the five years from December 31, 2014 through December 31, 2019 for (1) our common stock, (2) the S&P Small Cap 600 Index, (3) the NASDAQ-100 Technology Sector Index, and (4) the Russell 2000 Index. All values assume the reinvestment of any dividends; however, no dividends have been declared on our common stock to date. The stockholder return on the following graph is not necessarily indicative of future performance.

Comparison of Cumulative Total Return
Among Trupanion, S&P Small Cap 600 Index, NASDAQ-100 Technology Sector Index, and Russell 2000 Index



	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019
Trupanion Inc.	\$ 60.79	\$ 85.61	\$ 136.14	\$ 256.75	\$ 223.33	\$ 322.46
S&P Small Cap 600 Index	\$ 104.67	\$ 101.16	\$ 126.19	\$ 140.99	\$ 127.24	\$ 153.78
NASDAQ-100 Technology Sector Index	\$ 108.80	\$ 106.25	\$ 131.81	\$ 180.16	\$ 170.27	\$ 250.03
Russell 2000 Index	\$ 104.61	\$ 98.63	\$ 117.85	\$ 133.34	\$ 117.10	\$ 144.51

Item 6. Selected Financial Data

The selected statements of operations, balance sheet, and other data presented below should be read with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and our consolidated financial statements and related notes included elsewhere in this report. The selected statements of operations and balance sheet data are derived from our audited consolidated financial statements included elsewhere in this report and our previously audited financial statements that are not included herein. Our historical results are not necessarily indicative of the results to be expected in any future period.

	Year Ended December 31,				
	2019	2018	2017	2016	2015
	(in thousands)				
Consolidated statements of operations data:					
Revenue:					
Subscription business	\$ 321,163	\$ 263,738	\$ 218,354	\$ 173,356	\$ 133,406
Other business	62,773	40,218	24,313	14,874	13,557
Total revenue	383,936	303,956	242,667	188,230	146,963
Cost of revenue:					
Subscription business ⁽¹⁾	262,139	215,992	176,883	141,321	109,428
Other business	56,873	36,598	22,734	13,621	12,306
Total cost of revenue	319,012	252,590	199,617	154,942	121,734
Gross profit:					
Subscription business	59,024	47,746	41,471	32,035	23,978
Other business	5,900	3,620	1,579	1,253	1,251
Total gross profit	64,924	51,366	43,050	33,288	25,229
Operating expenses:					
Technology and development ⁽¹⁾	10,074	9,248	9,768	9,534	11,215
General and administrative ⁽¹⁾	20,967	18,164	16,820	15,205	15,558
Sales and marketing ⁽¹⁾	35,451	24,999	19,104	15,247	15,231
Total operating expenses	66,492	52,411	45,692	39,986	42,004
Gain (loss) from investment in joint venture	(352)	—	—	—	—
Operating loss	(1,920)	(1,045)	(2,642)	(6,698)	(16,775)
Interest expense	1,349	1,198	533	218	325
Other (income) expense, net	(1,629)	(1,309)	(1,244)	(58)	(9)
Loss before income taxes	(1,640)	(934)	(1,931)	(6,858)	(17,091)
Income tax expense (benefit)	169	(7)	(428)	38	114
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)	\$ (6,896)	\$ (17,205)

(1) Includes stock-based compensation expense as follows:

	Year Ended December 31,				
	2019	2018	2017	2016	2015
	(in thousands)				
Cost of revenue	\$ 1,050	\$ 927	\$ 594	\$ 275	\$ 263
Technology and development	364	209	216	246	404
General and administrative	3,312	2,304	1,887	1,893	1,889
Sales and marketing	2,120	1,335	722	532	446
Total stock-based compensation expense	\$ 6,846	\$ 4,775	\$ 3,419	\$ 2,946	\$ 3,002

	December 31,				
	2019	2018	2017	2016	2015
	(in thousands)				
Consolidated balance sheet data:					
Cash and cash equivalents	\$ 29,168	\$ 26,552	\$ 25,706	\$ 23,637	\$ 17,956
Short-term investments	69,732	54,559	37,590	29,570	25,288
Working capital	67,196	54,773	40,692	34,729	30,016
Total assets	257,200	207,510	105,859	82,345	70,917
Current and long-term debt	26,086	12,862	9,324	4,767	—
Total liabilities	120,440	78,337	57,425	37,630	25,561
Common stock and additional paid-in capital	232,731	219,838	134,511	129,574	122,844
Accumulated deficit	(85,520)	(83,711)	(82,784)	(81,281)	(74,385)
Total stockholders' equity	136,760	129,173	48,434	44,715	45,356

	Year Ended December 31,				
	2019	2018	2017	2016	2015
Other operational data⁽¹⁾:					
Total Business:					
Total pets enrolled (at period end)	646,728	521,326	423,194	343,649	291,818
Subscription Business:					
Total subscription pets enrolled	494,026	430,770	371,683	323,233	272,636
Monthly average revenue per pet	\$ 57.52	\$ 54.34	\$ 52.07	\$ 47.82	\$ 45.04
Lifetime value of a pet, including fixed expenses	\$ 523	\$ 449	\$ 409	\$ 290	\$ 95
Average pet acquisition cost (PAC) ⁽²⁾	\$ 212	\$ 164	\$ 152	\$ 123	\$ 132
Average monthly retention	98.58%	98.60%	98.63%	98.60%	98.64%

(1) For more information about how we calculate total pets enrolled, total subscription pets enrolled, monthly average revenue per pet, lifetime value of a pet, including fixed expenses, average pet acquisition cost and average monthly retention, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Key Operating Metrics.”

(2) Average pet acquisition cost is calculated in part based on net acquisition cost, a non-GAAP financial measure. For more information about net acquisition cost and a reconciliation of sales and marketing expenses to net acquisition cost, see “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Non-GAAP Financial Measures.”

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Please read the following discussion and analysis of our financial condition and results of operations together with our consolidated financial statements and related notes included under Part II, Item 8 of this Annual Report on Form 10-K.

This section of this Form 10-K generally discusses 2019 and 2018 items and year-to-year comparisons between 2019 and 2018. Discussions of 2017 items and year-to-year comparisons between 2018 and 2017 that are not included in this Form 10-K can be found in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Part II, Item 7 of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

Overview

We provide medical insurance for cats and dogs throughout the United States, Canada and Puerto Rico. Our data-driven, vertically-integrated approach enables us to provide pet owners with what we believe is the highest value medical insurance for their pets, priced specifically for each pet's unique characteristics. Our growing and loyal member base provides us with highly predictable and recurring revenue. We operate our business similar to other subscription-based businesses, with a focus on maximizing the estimated internal rate of return of an average pet.

We operate in two business segments: subscription business and other business. We generate revenue in our subscription business segment primarily from subscription fees for our medical insurance, which we market to consumers. Fees are paid at the beginning of each subscription period, which automatically renews on a monthly basis. We generate revenue in our other business segment by writing policies on behalf of third parties. We do not undertake the marketing efforts for these policies and have a business-to-business relationship with these third parties. Our other business segment also includes revenue from companies or organizations that choose to offer medical insurance for cats and dogs as a benefit to their employees or members, and contracts include multiple pets. The products in our other business segment may be materially different from our subscription business. Our ultimate goal is to build the Trupanion brand by continuing to offer the highest value proposition in the industry and maintain strong alignment with the veterinary community. We believe our activities in our other business segment benefit the overall market for pet medical insurance by expanding upon product options and distribution models within other market niches.

We generate leads for our subscription business through both third-party referrals and direct-to-consumer acquisition channels, which we then convert into members through our website and contact center. Veterinary hospitals represent our largest referral source. We engage our Territory Partners to have face-to-face visits with veterinarians and their staff. Territory Partners are dedicated to cultivating direct veterinary relationships and building awareness of the benefits of high quality medical insurance to veterinarians and their clients. Veterinarians then educate pet owners, who visit our website or call our contact center to learn more about, and potentially enroll in, Trupanion. We also receive a significant number of new leads from existing members adding pets and referring their friends and family members. Our direct-to-consumer acquisition channels serve as important resources for pet owner education and drive new member leads and conversion. We monitor average pet acquisition cost to evaluate the efficiency of our sales and marketing programs in acquiring new members and measure effectiveness based on our desired return on investment.

Key Operating Metrics

The following tables set forth our key operating metrics for the periods ended December 31, 2019, 2018 and 2017, and for each of the last eight fiscal quarters.

	Year Ended December 31,		
	2019	2018	2017
Total Business:			
Total pets enrolled (at period end)	646,728	521,326	423,194
Subscription Business:			
Total subscription pets enrolled (at period end)	494,026	430,770	371,683
Monthly average revenue per pet	\$ 57.52	\$ 54.34	\$ 52.07
Lifetime value of a pet, including fixed expenses	\$ 523	\$ 449	\$ 409
Average pet acquisition cost (PAC)	\$ 212	\$ 164	\$ 152
Average monthly retention	98.58%	98.60%	98.63%

	Period Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
Total Business:								
Total pets enrolled (at period end)	646,728	613,694	577,686	548,002	521,326	497,942	472,480	446,533
Subscription Business:								
Total subscription pets enrolled (at period end)	494,026	479,427	461,314	445,148	430,770	416,527	401,033	385,640
Monthly average revenue per pet	\$ 58.58	\$ 58.12	\$ 57.11	\$ 56.13	\$ 55.15	\$ 54.55	\$ 53.96	\$ 53.62
Lifetime value of a pet, including fixed expenses	\$ 523	\$ 511	\$ 482	\$ 471	\$ 449	\$ 435	\$ 431	\$ 419
Average pet acquisition cost (PAC)	\$ 222	\$ 208	\$ 213	\$ 205	\$ 186	\$ 155	\$ 150	\$ 165
Average monthly retention	98.58%	98.59%	98.57%	98.58%	98.60%	98.61%	98.64%	98.63%

Total pets enrolled. Total pets enrolled reflects the number of subscription pets or pets enrolled in one of the insurance products offered in our other business segment at the end of each period presented. We monitor total pets enrolled because it provides an indication of the growth of our consolidated business.

Total subscription pets enrolled. Total subscription pets enrolled reflects the number of pets in active memberships at the end of each period presented. We monitor total subscription pets enrolled because it provides an indication of the growth of our subscription business.

Monthly average revenue per pet. Monthly average revenue per pet is calculated as amounts billed in a given period for subscriptions divided by the total number of subscription pet months in the period. Total subscription pet months in a period represents the sum of all subscription pets enrolled for each month during the period. We monitor monthly average revenue per pet because it is an indicator of the per pet unit economics of our subscription business.

Lifetime value of a pet, including fixed expenses. Lifetime value of a pet, including fixed expenses, is calculated 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. This amount is also reduced by the fixed expenses related to our subscription business, which are the pro-rata portion of general and administrative and technology expenses, less stock-based compensation and depreciation, based on revenues. This amount, on a per pet basis, is 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 lifetime value of a pet, including fixed expenses, to estimate the value we might expect from new pets over their implied average subscriber life in months, if they behave like the average pet in that respective period. When evaluating the amount of sales and marketing expenses we may want to incur to attract new pet enrollments, we refer to the lifetime value of a pet, including fixed expenses, as well as our estimated internal rate of return calculation for an average pet, which also includes an estimated surplus capital charge, to inform the amount of acquisition spend in relation to the estimated payback period.

Starting with the year ended December 31, 2019, we have modified our calculation of lifetime value of a pet (LVP) to include fixed expenses in order to make this a more fulsome metric when evaluating the payback period compared to pet acquisition cost. The following table reflects the reconciliation of our historical presentation of LVP to lifetime value of a pet, including fixed expenses, for our subscription business in the periods indicated:

	Year Ended December 31,		
	2019	2018	2017
Lifetime value of a pet (LVP)	\$ 753	\$ 710	\$ 727
Minus: fixed expenses per pet	230	261	318
Lifetime value of a pet, including fixed expenses	\$ 523	\$ 449	\$ 409

Average pet acquisition cost. Average pet acquisition cost (PAC) is calculated as net acquisition cost divided by the total number of new subscription pets enrolled in that period. Net acquisition cost, a non-GAAP financial measure, is calculated in a reporting period as sales and marketing expense, excluding stock-based compensation expense and other business segment sales and marketing expense, offset by sign-up fee revenue. We exclude stock-based compensation expense because the amount varies from period to period based on number of awards issued and market-based valuation inputs. We offset sign-up fee revenue because it is a one-time charge to new members collected at the time of enrollment used to partially offset initial setup costs, which are included in sales and marketing expenses. We exclude other business segment sales and marketing expense because that does not relate to subscription enrollments. We monitor average pet acquisition cost to evaluate the efficiency of our sales and marketing programs in acquiring new members and measure effectiveness based on our desired return on investment.

Average monthly retention. Average monthly retention is measured as the monthly retention rate of enrolled subscription pets for each applicable period averaged over the 12 months prior to the period end date. As such, our average monthly retention rate as of December 31, 2019 is an average of each month's retention from January 1, 2019 through December 31, 2019. We calculate monthly retention as the number of pets that remain after subtracting all pets that cancel during a month, including pets that enroll and cancel within that month, divided by the total pets enrolled at the beginning of that month. We monitor average monthly retention because it provides a measure of member satisfaction and allows us to calculate the implied average subscriber life in months.

Non-GAAP Financial Measures

We believe that using net acquisition cost to calculate and present certain of our other key metrics is helpful to our investors and an important tool for financial and operational decision-making and evaluating our operating results over different periods of time. Measuring net acquisition cost by removing stock-based compensation expense and other business segment sales and marketing expense offset by sign-up fee revenue provides for a more comparable metric across periods.

This measure, which is a non-GAAP financial measure, may not provide information that is directly comparable to that provided by other companies in our industry. In addition, this measure excludes stock-based compensation expense, which has been, and is expected to continue to be for the foreseeable future, a significant recurring component of our sales and marketing expense. The presentation and utilization of non-GAAP financial measures is not meant to be considered in isolation or as a substitute for the directly comparable financial measures prepared in accordance with GAAP.

The following tables reflect the reconciliation of net acquisition cost to sales and marketing expense (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Sales and marketing expense	\$ 35,451	\$ 24,999	\$ 19,104
Net of sign-up fee revenue	(2,957)	(2,587)	(2,169)
Excluding:			
Stock-based compensation expense	(2,120)	(1,335)	(722)
Other business segment sales and marketing expense	(414)	(377)	(218)
Net acquisition cost	<u>\$ 29,960</u>	<u>\$ 20,700</u>	<u>\$ 15,995</u>

	Period Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
Sales and marketing expense	\$ 9,212	\$ 9,255	\$ 8,757	\$ 8,227	\$ 6,994	\$ 6,365	\$ 5,702	\$ 5,938
Net of sign-up fee revenue	(730)	(790)	(734)	(703)	(655)	(693)	(624)	(616)
Excluding:								
Stock-based compensation expense	(547)	(577)	(567)	(429)	(355)	(358)	(349)	(273)
Other business segment sales and marketing expense	(152)	(94)	(38)	(130)	(102)	(99)	(88)	(87)
Net acquisition cost	<u>\$ 7,783</u>	<u>\$ 7,794</u>	<u>\$ 7,418</u>	<u>\$ 6,965</u>	<u>\$ 5,882</u>	<u>\$ 5,215</u>	<u>\$ 4,641</u>	<u>\$ 4,962</u>

Components of Operating Results

General

We operate in two segments: subscription business and other business. Our subscription business segment includes revenue and expenses related to monthly subscriptions for our pet medical insurance, which we market directly to consumers. When we do not directly market to consumers, we classify the related revenue and expenses in our other business segment.

Revenue

We generate revenue in our subscription business segment primarily from subscription fees for our pet medical insurance. Fees are paid at the beginning of each subscription period, which automatically renews on a monthly basis. In most cases, our members authorize us to directly charge their credit card, debit card or bank account through automatic funds transfer. Subscription revenue is recognized on a pro rata basis over the monthly enrollment term. Membership may be canceled at any time without penalty, and we issue a refund for the unused portion of the canceled membership.

We generate revenue in our other business segment primarily from writing policies on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that may be materially different from our subscription.

Cost of Revenue

Cost of revenue in each of our segments is comprised of the following:

Veterinary invoice expense

Veterinary invoice expense includes our costs to review veterinary invoices, administer the payments, and provide member services, and other operating expenses directly or indirectly related to this process. We also accrue for veterinary invoices that have been incurred but not yet received. This also includes amounts paid by unaffiliated general agents, and an estimate of amounts incurred and not yet paid for our other business segment.

Other cost of revenue

Other cost of revenue for the subscription business segment includes direct and indirect member service expenses, Territory Partner renewal fees, credit card transaction fees and premium tax expenses. Other cost of revenue for the other business segment includes the commissions we pay to unaffiliated general agents, costs to administer the programs in the other business segment and premium taxes on the sales in this segment.

Operating Expenses

Our operating expenses are classified into three categories: technology and development, general and administrative, and sales and marketing. For each category, the largest component is personnel costs, which include salaries, employee benefit costs, bonuses and stock-based compensation expense.

Technology and Development

Technology and development expenses primarily consist of personnel costs and related expenses for our technology staff, which includes information technology development and infrastructure support, third-party services, as well as depreciation of hardware and capitalized software.

General and Administrative

General and administrative expenses consist primarily of personnel costs and related expenses for our finance, actuarial, human resources, regulatory, legal and general management functions, as well as facilities and professional services.

Sales and Marketing

Sales and marketing expenses primarily consist of the cost to educate veterinarians and consumers about the benefits of Trupanion, to generate leads and to convert leads into enrolled pets, as well as print, online and promotional advertising costs, and employee compensation and related costs. Sales and marketing expenses are driven primarily by investments to acquire new members.

Gain (loss) from investment in joint venture

Gain (loss) from investment in joint venture consists of the share of income and losses from our equity method investment in a joint venture, as well as income and expenses associated with administrative services provided to the joint venture.

Factors Affecting Our Performance

Average monthly retention. Our performance depends on our ability to continue to retain our existing and newly enrolled pets and is impacted by our ability to provide a best-in-class value and member experience. Our ability to retain enrolled pets depends on a number of factors, including the actual and perceived value of our services and the quality of our member experience, the ease and transparency of the process for reviewing and paying veterinary invoices for our members, and the competitive environment. In addition, other initiatives across our business may temporarily impact retention and make it difficult for us to improve or maintain this metric. For example, if the number of new pets enrolled increases at a faster rate than our historical experience, our average monthly retention rate could be adversely impacted, as our retention rate is generally lower during the first year of member enrollment.

Investment in pet acquisition. We have made and plan to continue to make significant investments to grow our member base. Our net acquisition cost and the number of new members we enroll depends on a number of factors, including the amount we elect to invest in sales and marketing activities in any particular period in the aggregate and by channel, the frequency of existing members adding a pet or referring their friends or family, effectiveness of our sales execution and marketing initiatives, changes in costs of media, the mix of our sales and marketing expenditures and the competitive environment. Our average pet acquisition cost has in the past significantly varied, and in the future may significantly vary, from period to period based upon specific marketing initiatives and estimated rates of return on pet acquisition spend. We also regularly test new member acquisition channels and marketing initiatives, which may be more expensive than our traditional marketing channels and may increase our average acquisition costs. We continually assess our sales and marketing activities by monitoring the estimated return on PAC spend both on a detailed level by acquisition channel and in the aggregate.

Timing of initiatives. Over time we plan to implement new initiatives to improve our member experience, make modifications to our subscription plan and find other ways to maintain a strong value proposition for our members. These initiatives will sometimes be accompanied by price adjustments, in order to compensate for an increase in benefits received by our members. The implementation of such initiatives may not always coincide with the timing of price adjustments, resulting in fluctuations in revenue and gross profit in our subscription business segment.

Geographic mix of sales. The relative mix of our business between the United States and Canada impacts the monthly average revenue per pet we receive. Prices for our plan in Canada are generally higher than in the United States (in local currencies), which is consistent with the relative cost of veterinary care in each country. As our mix of business between the United States and Canada changes, our metrics, such as our monthly average revenue per pet, and our exposure to foreign exchange fluctuations will be impacted. Any expansion into other international markets could have similar effects.

Other business segment. Our other business segment primarily includes revenue and expenses related to policies written on behalf of third parties. This segment includes products that have been in the past, and may be in the future, materially different from our subscription. Our relationships in our other business segment are generally subject to termination provisions and are non-exclusive. Accordingly, we cannot control the volume of business, even if a contract is not terminated. Loss of an entire program via contract termination could result in the associated policies and revenues being lost over a period of 12 to 18 months, which could have a material impact on our results of operations. We may enter into additional relationships in the future to the extent we believe they will be profitable to us, which could also impact our operating results.

Results of Operations

The following tables set forth our results of operations for the periods presented both in absolute dollars and as a percentage of total revenue for those periods. The period-to-period comparison of financial results is not necessarily indicative of future results.

	Year Ended December 31,		
	2019	2018	2017
	(in thousands)		
Revenue:			
Subscription business	\$ 321,163	\$ 263,738	\$ 218,354
Other business	62,773	40,218	24,313
Total revenue	383,936	303,956	242,667
Cost of revenue:			
Subscription business ⁽¹⁾	262,139	215,992	176,883
Other business	56,873	36,598	22,734
Total cost of revenue	319,012	252,590	199,617
Gross profit:			
Subscription business	59,024	47,746	41,471
Other business	5,900	3,620	1,579
Total gross profit	64,924	51,366	43,050
Operating expenses:			
Technology and development ⁽¹⁾	10,074	9,248	9,768
General and administrative ⁽¹⁾	20,967	18,164	16,820
Sales and marketing ⁽¹⁾	35,451	24,999	19,104
Total operating expenses	66,492	52,411	45,692
Gain (loss) from investment in joint venture	(352)	—	—
Operating loss	(1,920)	(1,045)	(2,642)
Interest expense	1,349	1,198	533
Other income, net	(1,629)	(1,309)	(1,244)
Loss before income taxes	(1,640)	(934)	(1,931)
Income tax expense (benefit)	169	(7)	(428)
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)

(1) Includes stock-based compensation expense as follows:

	Year Ended December 31,		
	2019	2018	2017
	(in thousands)		
Cost of revenue	\$ 1,050	\$ 927	\$ 594
Technology and development	364	209	216
General and administrative	3,312	2,304	1,887
Sales and marketing	2,120	1,335	722
Total stock-based compensation expense	\$ 6,846	\$ 4,775	\$ 3,419

	Year Ended December 31,		
	2019	2018	2017
	(as a percentage of revenue)		
Revenue	100 %	100 %	100 %
Cost of revenue	83	83	82
Gross profit	17	17	18
Operating expenses:			
Technology and development	3	3	4
General and administrative	5	6	7
Sales and marketing	9	8	8
Total operating expenses	17	17	19
Operating loss	(1)	—	(1)
Interest expense	—	—	—
Other (income) expense, net	—	—	(1)
Loss before income taxes	—	—	(1)
Income tax expense (benefit)	—	—	—
Net loss	— %	— %	(1)%

	Year Ended December 31,		
	2019	2018	2017
	(as a percentage of subscription revenue)		
Subscription business revenue	100%	100%	100%
Subscription business cost of revenue	82	82	81
Subscription business gross profit	18%	18%	19%

Comparison of the years ended December 31, 2019, 2018, and 2017

Revenue

	Year Ended December 31,			Change	
	2019	2018	2017	2019 vs. 2018	2018 vs. 2017
	(in thousands, except percentages, pet and per pet data)				
Revenue:					
Subscription business	\$ 321,163	\$ 263,738	\$ 218,354	22%	21%
Other business	62,773	40,218	24,313	56	65
Total revenue	\$ 383,936	\$ 303,956	\$ 242,667	26	25
Percentage of Revenue by Segment:					
Subscription business	84%	87%	90%		
Other business	16	13	10		
Total revenue	100%	100%	100%		
Total pets enrolled (at period end)	646,728	521,326	423,194	24	23
Total subscription pets enrolled (at period end)	494,026	430,770	371,683	15	16
Monthly average revenue per pet	\$ 57.52	\$ 54.34	\$ 52.07	6	4
Average monthly retention	98.58%	98.60%	98.63%		

Year ended December 31, 2019 compared to year ended December 31, 2018. Total revenue increased by \$80.0 million to \$383.9 million for the year ended December 31, 2019, or 26%. Revenue from our subscription business segment increased by \$57.4 million to \$321.2 million for the year ended December 31, 2019, or 22%. This increase was primarily due to a 15% increase in total subscription pets enrolled as of December 31, 2019 compared to December 31, 2018 and increased average revenue per pet of 6% for the same period. Increases in pricing were due to the increased cost and utilization of veterinary care. Revenue from our other business segment increased by \$22.6 million to \$62.8 million for the year ended December 31, 2019, or 56%, primarily due to the increase in enrolled pets in this segment.

Cost of Revenue

	Year Ended December 31,			Change	
	2019	2018	2017	2019 vs. 2018	2018 vs. 2017
(in thousands, except percentages, pet and per pet data)					
Cost of Revenue:					
Subscription business:					
Veterinary invoice expense	\$ 232,415	\$ 191,051	\$ 155,554	22%	23%
Other cost of revenue	29,724	24,941	21,329	19	17
Total cost of revenue	262,139	215,992	176,883	21	22
Gross profit	59,024	47,746	41,471	24	15
Other business:					
Veterinary invoice expense	38,532	23,488	14,568	64	61
Other cost of revenue	18,341	13,110	8,166	40	61
Total cost of revenue	56,873	36,598	22,734	55	61
Gross profit	\$ 5,900	\$ 3,620	\$ 1,579	63	129
Percentage of Revenue by Segment:					
Subscription business:					
Veterinary invoice expense	72%	72%	71%		
Other cost of revenue	9	9	10		
Total cost of revenue	82	82	81		
Gross profit	18	18	19		
Other business:					
Veterinary invoice expense	61	58	60		
Other cost of revenue	29	33	34		
Total cost of revenue	91	91	94		
Gross profit	9	9	6		
Total pets enrolled (at period end)	646,728	521,326	423,194	24	23
Total subscription pets enrolled (at period end)	494,026	430,770	371,683	15	16
Monthly average revenue per pet	\$ 57.52	\$ 54.34	\$ 52.07	6	4

Year ended December 31, 2019 compared to year ended December 31, 2018. Cost of revenue for our subscription business segment was \$262.1 million, or 82% of revenue, for the year ended December 31, 2019, compared to \$216.0 million, or 82%, of revenue for the year ended December 31, 2018. This \$46.1 million increase in subscription cost of revenue was primarily the result of a 15% increase in subscription pets enrolled and an increase of 6% in veterinary invoice expense per pet due to increases in the cost and utilization of veterinary care. Cost of revenue for our other business segment increased by \$20.3 million, or 55%, to \$56.9 million for the year ended December 31, 2019, primarily due to the increase in enrolled pets in this segment.

Technology and Development Expenses

	Year Ended December 31,			Change	
	2019	2018	2017	2019 vs. 2018	2018 vs. 2017
	(in thousands, except percentages)				
Technology and development	\$ 10,074	\$ 9,248	\$ 9,768	9%	(5)%
Percentage of total revenue	3%	3%	4%		

Year ended December 31, 2019 compared to year ended December 31, 2018. Technology and development expenses increased by \$0.8 million, or 9%, to \$10.1 million for the year ended December 31, 2019. The change was primarily due to a \$1.0 million increase in compensation and third party contractor expenses, net of capitalization, partially offset by a \$0.4 million decrease in depreciation and amortization expenses. Technology and development expenses remained consistent at 3% as a percentage of revenue year over year.

General and Administrative Expenses

	Year Ended December 31,			Change	
	2019	2018	2017	2019 vs. 2018	2018 vs. 2017
	(in thousands, except percentages)				
General and administrative	\$ 20,967	\$ 18,164	\$ 16,820	15%	8%
Percentage of total revenue	5%	6%	7%		

Year ended December 31, 2019 compared to year ended December 31, 2018. General and administrative expenses increased by \$2.8 million, or 15%, to \$21.0 million for the year ended December 31, 2019. The change was primarily due to a \$3.1 million increase in compensation expenses, a \$0.8 million increase in professional service fees, and a \$1.5 million increase in depreciation expense mainly due to owning our home office building since August 2018, partially offset by a total of \$2.6 million in savings from additional lease income and less rental expense. General and administrative expenses decreased from 6% to 5% as a percentage of revenue for the year ended December 31, 2019, as we experienced scale in our support functions.

Sales and Marketing Expenses

	Year Ended December 31,			Change	
	2019	2018	2017	2019 vs. 2018	2018 vs. 2017
	(in thousands, except pet and per pet data)				
Sales and marketing	\$ 35,451	\$ 24,999	\$ 19,104	42%	31%
Percentage of total revenue	9%	8%	8%		
Subscription Business:					
Total subscription pets enrolled (at period end)	494,026	430,770	371,683	15	16
Average pet acquisition cost (PAC)	\$ 212	\$ 164	\$ 152	29	8

Year ended December 31, 2019 compared to year ended December 31, 2018. Sales and marketing expense increased by \$10.5 million, or 42%, to \$35.5 million, for the year ended December 31, 2019. The change was primarily due to a 34% increase in headcount mainly within the account management, conversion and content teams, as well as an approximate \$3.5 million increase in other sales and marketing initiatives primarily related to conversion. Sales and marketing expenses were 9% as a percentage of revenue for the year ended December 31, 2019, compared to 8% in the prior year.

Total Other (Income) Expense, Net

	Year Ended December 31,		
	2019	2018	2017
	(in thousands)		
Interest expense	\$ 1,349	\$ 1,198	\$ 533
Other income, net	(1,629)	(1,309)	(1,244)
Total other (income) expense, net	<u>\$ (280)</u>	<u>\$ (111)</u>	<u>\$ (711)</u>

Year ended December 31, 2019 compared to year ended December 31, 2018. Total other (income) expense, net increased by \$0.2 million, primarily due to higher interest income from increased investment balance, partially offset by higher interest expense on debt.

Income Tax Expense (Benefit)

	Year Ended December 31,		
	2019	2018	2017
	(in thousands, except percentages)		
Income tax expense (benefit)	\$ 169	\$ (7)	\$ (428)
Effective tax rate	(10.3)%	0.8%	22.2%

Year ended December 31, 2019 compared to year ended December 31, 2018. The change in our effective tax rate from 2018 to 2019 was primarily caused by an increase in our net deferred tax liability resulting from an increase in the effective state tax rate.

Quarterly Results of Operations

The following tables contain selected quarterly financial information for the years ended December 31, 2019 and 2018. The unaudited quarterly information has been prepared on a basis consistent with the audited consolidated financial statements and includes all adjustments that we consider necessary for a fair presentation of the information shown. These quarterly operating results for any fiscal quarter are not necessarily indicative of the operating results for any full fiscal year or future period.

Consolidated Statements of Operations Data:

	Three Months Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
	(in thousands)							
Revenue:								
Subscription business	\$ 86,592	\$ 82,613	\$ 77,736	\$ 74,222	\$ 70,933	\$ 67,421	\$ 63,867	\$ 61,517
Other business	18,891	16,663	14,463	12,756	11,707	10,743	9,525	8,243
Total revenue	105,483	99,276	92,199	86,978	82,640	78,164	73,392	69,760
Cost of revenue:								
Subscription business ⁽¹⁾	70,718	66,770	64,264	60,387	57,892	54,753	52,333	51,014
Other business	17,031	15,061	13,222	11,559	10,543	9,667	8,706	7,682
Total cost of revenue	87,749	81,831	77,486	71,946	68,435	64,420	61,039	58,696
Gross profit:								
Subscription business	15,874	15,843	13,472	13,835	13,041	12,668	11,534	10,503
Other business	1,860	1,602	1,241	1,197	1,164	1,076	819	561
Total gross profit	17,734	17,445	14,713	15,032	14,205	13,744	12,353	11,064
Operating expenses:								
Technology and development ⁽¹⁾	2,556	2,271	2,578	2,669	2,487	2,299	2,298	2,164
General and administrative ⁽¹⁾	5,312	5,017	5,219	5,419	4,922	4,174	4,610	4,458
Sales and marketing ⁽¹⁾	9,212	9,255	8,757	8,227	6,994	6,365	5,702	5,938
Total operating expenses	17,080	16,543	16,554	16,315	14,403	12,838	12,610	12,560
Gain (loss) from investment in joint venture	(21)	(59)	(272)	—	—	—	—	—
Operating income (loss)	633	843	(2,113)	(1,283)	(198)	906	(257)	(1,496)
Interest expense	375	340	317	317	311	336	332	219
Other income, net	(535)	(297)	(453)	(344)	(238)	(628)	(303)	(140)
Income (loss) before income taxes	793	800	(1,977)	(1,256)	(271)	1,198	(286)	(1,575)
Income tax expense (benefit)	157	18	(46)	40	4	(7)	91	(95)
Net income (loss)	\$ 636	\$ 782	\$ (1,931)	\$ (1,296)	\$ (275)	\$ 1,205	\$ (377)	\$ (1,480)

(1) Includes stock-based compensation expense as follows (in thousands):

	Three Months Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
	(in thousands)							
Cost of revenue	\$ 267	\$ 258	\$ 278	\$ 247	\$ 230	\$ 249	\$ 252	\$ 197
Technology and development	97	94	110	63	42	58	60	49
General and administrative	860	916	918	618	595	634	625	449
Sales and marketing	547	577	567	429	355	358	349	273
Total stock-based compensation expense	\$ 1,771	\$ 1,845	\$ 1,873	\$ 1,357	\$ 1,222	\$ 1,299	\$ 1,286	\$ 968

	Period Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
Other Financial and Operational Data:								
Total Business:								
Total pets enrolled (at period end)	646,728	613,694	577,686	548,002	521,326	497,942	472,480	446,533
Subscription Business:								
Total subscription pets enrolled (at period end)	494,026	479,427	461,314	445,148	430,770	416,527	401,033	385,640
Monthly average revenue per pet	\$ 58.58	\$ 58.12	\$ 57.11	\$ 56.13	\$ 55.15	\$ 54.55	\$ 53.96	\$ 53.62
Lifetime value of a pet, including fixed expenses	\$ 523	\$ 511	\$ 482	\$ 471	\$ 449	\$ 435	\$ 431	\$ 419
Average pet acquisition cost (PAC)	\$ 222	\$ 208	\$ 213	\$ 205	\$ 186	\$ 155	\$ 150	\$ 165
Average monthly retention	98.58%	98.59%	98.57%	98.58%	98.60%	98.61%	98.64%	98.63%

	Three Months Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
	(as a percentage of revenue)							
Revenue	100%	100%	100 %	100 %	100 %	100%	100 %	100 %
Cost of revenue	83	82	84	83	83	82	83	84
Gross profit	17	18	16	17	17	18	17	16
Operating expenses:								
Technology and development	2	2	3	3	3	3	3	3
General and administrative	5	5	6	7	6	5	6	6
Sales and marketing	9	9	9	9	8	8	8	8
Total operating expenses	16	17	18	19	17	16	17	18
Gain (loss) from investment in joint venture	—	—	—	—	—	—	—	—
Operating income (loss)	1	1	(2)	(1)	—	1	—	(3)
Interest expense	—	—	—	—	—	—	—	—
Other income, net	(1)	—	—	—	—	(1)	—	—
Income (loss) before income taxes	1	1	(2)	(1)	—	2	—	(2)
Income tax expense (benefit)	—	—	—	—	—	—	—	—
Net income (loss)	1%	1%	(2)%	(1)%	— %	2%	(1)%	(2)%

	Three Months Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
	(as a percentage of subscription revenue)							
Subscription business revenue	100%	100%	100%	100%	100%	100%	100%	100%
Subscription business cost of revenue	82	81	83	81	82	81	82	83
Subscription business gross profit	18%	19%	17%	19%	18%	19%	18%	17%

Liquidity and Capital Resources

The following table summarizes our cash flows for the periods indicated (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Net cash provided by operating activities	\$ 16,157	\$ 12,680	\$ 9,666
Net cash used in investing activities	(28,008)	(81,451)	(13,056)
Net cash provided by financing activities	14,044	71,229	5,081
Effect of exchange rates on cash and cash equivalents	423	(812)	378
Net change in cash, cash equivalents, and restricted cash	\$ 2,616	\$ 1,646	\$ 2,069

Our primary sources of liquidity are cash provided by operations and available borrowings on our line of credit. In June 2018, we increased the borrowing capacity on our line of credit from \$30.0 million to \$50.0 million. In addition, we completed the June 2018 follow-on public offering, raising aggregate net proceeds of \$65.7 million, primarily to fund the purchase of our home office building in August 2018. Our primary requirements for liquidity are paying veterinary invoices, funding operations and capital requirements, investing in new member acquisition, investing in enhancements to our member experience, and servicing debt.

As of December 31, 2019, we had \$98.9 million of cash, cash equivalents, and short-term investments and \$23.3 million available under our line of credit, which excluded \$0.5 million reserved for ancillary services. Most of the assets in our insurance subsidiary, American Pet Insurance Company (APIC), and our segregated cell business, Wyndham Insurance Company (SAC) Limited (WICL) Segregated Account AX, are subject to certain capital and dividend rules and regulations prescribed by jurisdictions in which they are authorized to operate. As of December 31, 2019, total assets and liabilities held outside of our insurance entities were \$94.2 million and \$42.0 million, respectively, including \$5.3 million of cash and cash equivalents that were segregated from other operating funds and held in trust for the payment of veterinary invoices on behalf of our insurance subsidiaries.

We believe our cash and cash equivalents, short-term investments and line of credit are sufficient to fund our operations and capital requirements for the next 12 months. As we continue to grow, however, we may explore additional financing to fund our operations or to meet capital requirements. Financing could include equity, equity-linked, or debt financing. Additional financing may not be available to us on acceptable terms, or at all.

In November 2019, our board of directors approved a share repurchase program, pursuant to which we may repurchase up to \$15.0 million of our outstanding shares over the next 12 months. Each quarter throughout this period, we intend to establish repurchase parameters reflecting our business's capital allocation priorities, the market price of our common stock and general market conditions. We cannot predict when or if we will repurchase any shares of common stock, as such repurchases will depend on a number of factors, some of which are beyond our control. We did not repurchase any shares under this program for the year ended December 31, 2019.

Operating Cash Flows

We derive operating cash flows from the sale of our subscription plans, which is used to pay veterinary invoices and other cost of revenue. Additionally, cash is used to support the growth of our business by reinvesting to acquire new pet enrollments and to fund projects that improve our members' experience. Cash provided by operating activities was \$16.2 million for the year ended December 31, 2019, compared to cash provided by operating activities of \$12.7 million for the year ended December 31, 2018. The \$3.5 million increase was primarily driven by increased pet count and scale in our operating departments, as well as timing differences between collections from members and payments of veterinary invoices and payments to vendors. Changes in accounts receivable were primarily related to annual policies with monthly payment terms within our other business segment.

Investing Cash Flows

Net cash used in investing activities for the year ended December 31, 2019 was primarily related to the net purchase of investments to increase our statutory capital. As of December 31, 2019, we had \$74.0 million in short-term and long-term investments in our insurance entities, APIC and WICL Segregated Account AX. These investments are held to satisfy statutory requirements and we anticipate that we will need to maintain greater amounts of risk-based capital if our pet enrollments continue to grow. Net cash used in investing activities decreased by \$53.4 million for the year over year, primarily related to the \$55.0 million cash portion of the building acquisition in August 2018.

Financing Cash Flows

Cash provided by financing activities was \$14.0 million and \$71.2 million for the years ended December 31, 2019 and 2018, respectively. The decrease of \$57.2 million was primarily due to net proceeds of \$65.7 million received from the June 2018 follow-on public offering, partially offset by a \$10.0 million repayment of the line of credit in the prior year.

Long-Term Debt

Pacific Western Bank Loan and Security Agreement

We have a syndicated loan agreement with Pacific Western Bank (PWB) and Western Alliance Bank (WAB), providing us a revolving line of credit of up to \$50.0 million with a maturity date in June 2022. We refer to this line of credit as our PWB credit facility. The maximum amount available to us under the PWB credit facility, inclusive of any amounts outstanding under the revolving line of credit, is the lesser of \$50.0 million or the total amount of cash and securities held by our insurance entities, less amounts outstanding relating to other ancillary services and letters of credit, totaling \$0.5 million as of December 31, 2019. Interest on the PWB credit facility accrues at a variable annual rate equal to the greater of 4.5% or 0.75% plus the prime rate (5.50% at December 31, 2019).

The PWB credit facility requires us to maintain certain financial and non-financial covenants, including maintaining a minimum cash balance of \$1.4 million in our account at WAB and/or WAB affiliates and other cash or investments of \$2.1 million in our accounts at PWB. As of December 31, 2019, we were in compliance with each of the financial and non-financial covenants.

Our obligations under the PWB credit facility are secured by substantially all of our assets and a pledge of certain of our subsidiaries' stock. As of December 31, 2019, we had \$26.2 million in aggregate borrowings outstanding under the PWB credit facility.

Contractual Obligations

We enter into long-term contractual obligations and commitments in the normal course of business, primarily debt obligations and non-cancellable vendor service agreements. For enforceable and legally binding contracts, our contractual cash obligations as of December 31, 2019 are set forth below (in thousands):

	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Long-term debt obligations ⁽¹⁾	\$ 26,200	\$ —	\$ 26,200	\$ —	\$ —
Lease obligations	90	40	50	—	—
Other obligations ⁽²⁾	7,594	3,320	1,573	405	2,296
Total	<u>\$ 33,884</u>	<u>\$ 3,360</u>	<u>\$ 27,823</u>	<u>\$ 405</u>	<u>\$ 2,296</u>

(1) Consists of our revolving line of credit. Excludes interest of the greater of 4.5% or 0.75% plus the prime rate (5.50% at December 31, 2019).

(2) Consists of contractual obligations from non-cancellable vendor service agreements.

Critical Accounting Policies and Significant Estimates

Our discussion and analysis of our financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with GAAP. The preparation of these consolidated financial statements requires us to make estimates and judgments that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities as of the date of the consolidated financial statements, as well as the reported revenue and expenses during the reporting periods.

Critical accounting policies and estimates are those that we consider the most important to the portrayal of our financial condition and results of operations because they require our most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Generally, we base our estimates on historical experience and on various other factors that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

Reserve for Veterinary Invoices

We use the paid loss development method (chain-ladder method) to estimate reserves for veterinary invoices for our subscription and for the majority of our other business segment. Paid loss development factors are estimated based on historical paid loss triangles. The reserve represents our estimate of the future amount we will pay for veterinary invoices that are dated as of, or prior to, our balance sheet date. The reserve also includes our estimate of related internal processing costs. To determine the accrual, we make assumptions based on our historical experience, including the number of veterinary invoices we expect to receive, the average cost of those veterinary invoices, the length of time between the date of the veterinary invoice and the date we receive it, and our expected cost to process and administer the payments. As of each balance sheet date, we reevaluate our reserve and may adjust the estimate for new information.

As of December 31, 2019, our reserve for veterinary invoices was \$21.2 million, consisting of \$19.2 million for the amount we expect to pay in the future for veterinary invoices dated between January 1, 2019 and December 31, 2019, inclusive of related processing costs, and a reserve of \$2.0 million for invoices dated prior to January 1, 2019. We believe the reserve amount as of December 31, 2019 is adequate, and we do not believe that there are any reasonably likely changes in the facts or circumstances underlying key assumptions that would result in the reserve balance being insufficient in an amount that would have a material impact on our reported results, financial position or liquidity. The ultimate liability, however, may be in excess of or less than the amount we have reserved.

For the year ended December 31, 2019, we paid \$14.3 million for veterinary invoices dated on or before December 31, 2018, including related processing costs. Our reserve estimate for these expenses was \$16.1 million as of December 31, 2018. As of December 31, 2019, we reevaluated the remaining reserve for those periods prior to December 31, 2018 and recorded an adjustment to our income statement to increase it by \$0.2 million.

Income Taxes

We determine our deferred tax assets and liabilities based on the differences between the financial reporting and tax basis of assets and liabilities. The deferred tax assets and liabilities are measured using the enacted tax rates that will be in effect when the differences are expected to reverse. A valuation allowance is recorded when it is more likely than not that the deferred tax asset will not be recovered. We apply judgment in the determination of the consolidated financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Although we believe our assumptions, judgments and estimates are reasonable, changes in tax laws or our interpretation of tax laws and the resolution of any tax audits could significantly impact the amounts provided for income taxes in our consolidated financial statements.

Stock-Based Compensation

Compensation expense related to stock-based transactions, including employee and non-employee stock option awards, restricted stock awards, and restricted stock units, is measured and recognized in the financial statements based on fair value. The fair value of stock options is estimated on the measurement date using the Black-Scholes option-pricing model that requires management to apply judgment and make estimates, including:

- *Expected volatility*—We estimate the expected volatility based on the historical volatility of a representative group of publicly traded companies with similar characteristics to us, and our own historical volatility;
- *Expected term for awards granted to employees*—We have based our expected term for awards issued to employees on the simplified method, as permitted by the SEC Staff Accounting Bulletin Topic 14, Share-Based Payment;
- *Risk-free interest rate*—The risk-free interest rate is based on the yields of U.S. Treasury securities with maturities similar to the expected term of the options; and
- *Expected dividend yield*—We have never declared or paid any cash dividends and do not presently plan to pay cash dividends in the foreseeable future. Consequently, we use an expected dividend yield of zero.

Stock-based compensation expense for stock options, restricted stock awards, and restricted stock units is recognized on a straight-line basis over the requisite service period, which is generally the vesting period of the respective award. We recognize forfeitures when they occur.

Item 7A. Quantitative and Qualitative Disclosures About Market Risks

We are exposed to market risks in the ordinary course of business, primarily related to interest rate sensitivities and foreign currency exchange risk.

Interest Rate Risk

We are exposed to interest rate risk as a result of our debt and our investment activities. Our revolving line of credit with PWB and WAB bears interest at the rate of the greater of 4.5% or 0.75% plus the prime rate. As of December 31, 2019, our aggregate outstanding indebtedness was \$26.2 million. The primary objective of our investment activities is to maintain principal and the majority of our investments are short-term in nature. A 10% change in market interest rates would not be expected to have a material impact on our consolidated financial condition or results of operations.

Foreign Currency Exchange Risk

We generate approximately 18% of our revenue in Canada. As our operations in Canada or the United States grow on an absolute basis and/or relative to one another, our results of operations and cash flows will be subject to fluctuations due to changes in foreign currency exchange rates. A 10% change in the Canadian currency exchange rate could have a material impact on our consolidated financial condition or results of operations. A hypothetical change of this magnitude would have increased or decreased our total revenues by approximately \$6.8 million, total expenses by approximately \$4.8 million, and have a net impact of \$2.0 million of income or loss for the year ended December 31, 2019. To date, we have not entered into any material foreign currency hedging contracts although we may do so in the future.

Item 8. Financial Statements and Supplementary Data

Trupanion, Inc. Index to Consolidated Financial Statements

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Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of Trupanion, Inc.

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Trupanion, Inc. (the Company) as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2019, and the related notes and the financial statement schedule listed in the Index at Item 15(a) (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2019 and 2018, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2019, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the Company's internal control over financial reporting as of December 31, 2019, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework), and our report dated February 13, 2020 expressed an unqualified opinion thereon.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical audit matter

The critical audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of the critical audit matter does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the account or disclosure to which it relates.

Reserve for Veterinary Invoices

Description of the Matter

The Company's reserve for veterinary invoices totaled \$21.2 million as of December 31, 2019. As discussed in Note 1 to the financial statements, the Company's reserve for veterinary invoices is based on an actuarial analysis of the Company's historical experience including the number of veterinary invoices it expects to receive, the average cost of those veterinary invoices, the length of time between the date of the veterinary invoice and the date the Company receives the veterinary invoice, the members' chosen deductibles and the Company's expected cost to process and administer payments.

Auditing the Company's reserve for veterinary invoices is complex due to the sensitivity of the estimated reserve to management assumptions including frequency and severity of loss and development factors applied to paid and reported invoices.

How We Addressed the Matter in Our Audit

We evaluated the design and tested the operating effectiveness of controls over the reserve for veterinary invoices process, including controls over the completeness and accuracy of the data used in management's actuarial projections and the review and approval processes that management has in place for the methods and assumptions used by management's actuaries in estimating the reserves.

To evaluate the reserve for veterinary invoices, our audit procedures included, among others, testing the completeness and accuracy of the underlying invoice data and related contracts. We involved our actuarial specialists to assist in our evaluation of management's methodologies and assumptions used in the calculation of the reserve and compared the Company's recorded reserve to a range of reasonable estimates developed independently by our actuarial specialists.

/s/ Ernst & Young LLP

We have served as the Company's auditor since 2012.

Seattle, Washington
February 13, 2020

Trupanion, Inc.
Consolidated Statements of Operations
(in thousands, except per share data)

	Year Ended December 31,		
	2019	2018	2017
Revenue	\$ 383,936	\$ 303,956	\$ 242,667
Cost of revenue:			
Veterinary invoice expense	270,947	214,539	170,122
Other cost of revenue	48,065	38,051	29,495
Gross profit	64,924	51,366	43,050
Operating expenses:			
Technology and development	10,074	9,248	9,768
General and administrative	20,967	18,164	16,820
Sales and marketing	35,451	24,999	19,104
Total operating expenses	66,492	52,411	45,692
Gain (loss) from investment in joint venture	(352)	—	—
Operating loss	(1,920)	(1,045)	(2,642)
Interest expense	1,349	1,198	533
Other income, net	(1,629)	(1,309)	(1,244)
Loss before income taxes	(1,640)	(934)	(1,931)
Income tax expense (benefit)	169	(7)	(428)
Net loss	<u>\$ (1,809)</u>	<u>\$ (927)</u>	<u>\$ (1,503)</u>
Net loss per share:			
Basic and Diluted	\$ (0.05)	\$ (0.03)	\$ (0.05)
Weighted average shares of common stock outstanding:			
Basic and Diluted	34,645,345	31,961,192	29,588,324

Trupanion, Inc.
Consolidated Statements of Comprehensive Loss
(in thousands)

	Year Ended December 31,		
	2019	2018	2017
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)
Other comprehensive income (loss):			
Foreign currency translation adjustments	359	(642)	277
Net unrealized gain (loss) on available-for-sale debt securities	644	(19)	8
Other comprehensive income (loss), net of taxes	1,003	(661)	285
Comprehensive loss	<u>\$ (806)</u>	<u>\$ (1,588)</u>	<u>\$ (1,218)</u>

Trupanion, Inc.
Consolidated Balance Sheets
(in thousands, except share data)

	December 31,	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 29,168	\$ 26,552
Short-term investments	69,732	54,559
Accounts and other receivables	54,408	31,565
Prepaid expenses and other assets	5,513	5,300
Total current assets	158,821	117,976
Restricted cash	1,400	1,400
Long-term investments, at fair value	4,323	3,554
Property and equipment, net	70,372	69,803
Intangible assets, net	7,731	8,071
Other long-term assets	14,553	6,706
Total assets	<u>\$ 257,200</u>	<u>\$ 207,510</u>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 4,087	\$ 2,767
Accrued liabilities and other current liabilities	13,798	11,347
Reserve for veterinary invoices	21,194	16,062
Deferred revenue	52,546	33,027
Total current liabilities	91,625	63,203
Long-term debt	26,086	12,862
Deferred tax liabilities	1,118	1,002
Other liabilities	1,611	1,270
Total liabilities	120,440	78,337
Stockholders' equity:		
Common stock: \$0.00001 par value per share, 100,000,000 shares authorized at December 31, 2019 and December 31, 2018, 35,876,882 and 34,947,017 shares issued and outstanding at December 31, 2019; 34,781,121 and 34,025,136 shares issued and outstanding at December 31, 2018	—	—
Preferred stock: \$0.00001 par value per share, 10,000,000 shares authorized at December 31, 2019 and December 31, 2018, and 0 shares issued and outstanding at December 31, 2019 and December 31, 2018	—	—
Additional paid-in capital	232,731	219,838
Accumulated other comprehensive income (loss)	250	(753)
Accumulated deficit	(85,520)	(83,711)
Treasury stock, at cost: 929,865 shares at December 31, 2019 and 755,985 shares at December 31, 2018	(10,701)	(6,201)
Total stockholders' equity	136,760	129,173
Total liabilities and stockholders' equity	<u>\$ 257,200</u>	<u>\$ 207,510</u>

Trupanion, Inc.
Consolidated Statements of Stockholders' Equity
(in thousands, except share amounts)

	Common Stock		Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
	Shares	Amount					
Balance at January 1, 2017	29,498,947	\$ —	\$ 129,574	\$ (81,281)	\$ (377)	\$ (3,201)	44,715
Issuance of common stock in connection with the Company's equity award programs, net of tax withholdings	622,549	—	1,375	—	—	—	1,375
Stock-based compensation expense	—	—	3,562	—	—	—	3,562
Other comprehensive income	—	—	—	—	285	—	285
Net loss	—	—	—	(1,503)	—	—	(1,503)
Balance at December 31, 2017	30,121,496	—	134,511	(82,784)	(92)	(3,201)	48,434
Issuance of common stock from follow-on public offering	2,090,909	—	65,638	—	—	—	65,638
Issuance of common stock for acquisition of corporate real estate	303,030	—	9,633	—	—	—	9,633
Exercise of warrants, net	231,315	—	3,300	—	—	(3,000)	300
Issuance of common stock in connection with the Company's equity award programs, net of tax withholdings	1,278,386	—	1,806	—	—	—	1,806
Stock-based compensation expense	—	—	4,950	—	—	—	4,950
Other comprehensive income	—	—	—	—	(661)	—	(661)
Net loss	—	—	—	(927)	—	—	(927)
Balance at December 31, 2018	34,025,136	—	219,838	(83,711)	(753)	(6,201)	129,173
Exercise of warrants, net	306,120	—	4,800	—	—	(4,500)	300
Issuance of common stock in connection with the Company's equity award programs, net of tax withholdings	615,761	—	1,043	—	—	—	1,043
Stock-based compensation expense	—	—	7,050	—	—	—	7,050
Other comprehensive income	—	—	—	—	1,003	—	1,003
Net loss	—	—	—	(1,809)	—	—	(1,809)
Balance at December 31, 2019	34,947,017	\$ —	\$ 232,731	\$ (85,520)	\$ 250	\$ (10,701)	136,760

Trupanion, Inc.
Consolidated Statements of Cash Flows
(in thousands)

	Year Ended December 31,		
	2019	2018	2017
Operating activities			
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)
Adjustments to reconcile net loss to cash provided by operating activities:			
Depreciation and amortization	5,632	4,512	4,232
Stock-based compensation expense	6,846	4,775	3,419
Gain on sale of equity method investment	—	—	(1,036)
Other, net	105	(240)	(383)
Changes in operating assets and liabilities:			
Accounts and other receivables	(22,772)	(11,248)	(10,219)
Prepaid expenses and other assets	(432)	(2,628)	(179)
Accounts payable, accrued liabilities, and other liabilities	4,110	4,531	3,019
Reserve for veterinary invoices	5,059	3,440	3,149
Deferred revenue	19,418	10,465	9,167
Net cash provided by operating activities	16,157	12,680	9,666
Investing activities			
Purchases of investment securities	(65,506)	(52,862)	(31,920)
Maturities of investment securities	49,762	35,413	23,372
Purchases of other investments	(4,000)	(3,000)	—
Acquisition of lease intangibles, related to corporate real estate acquisition	—	(2,959)	—
Proceeds from sale of equity method investment	—	—	1,402
Purchases of property and equipment	(5,373)	(56,936)	(3,131)
Other	(2,891)	(1,107)	(2,779)
Net cash used in investing activities	(28,008)	(81,451)	(13,056)
Financing activities			
Proceeds from public offering of common stock, net of offering costs	—	65,671	—
Proceeds from exercise of stock options	2,982	3,601	2,545
Shares withheld to satisfy tax withholding	(1,667)	(1,839)	(1,170)
Proceeds from debt financing, net of financing fees	13,167	13,431	4,400
Repayment of debt financing	—	(10,000)	—
Other financing	(438)	365	(694)
Net cash provided by financing activities	14,044	71,229	5,081
Effect of foreign exchange rate changes on cash, cash equivalents, and restricted cash, net	423	(812)	378
Net change in cash, cash equivalents, and restricted cash	2,616	1,646	2,069
Cash, cash equivalents, and restricted cash at beginning of period	27,952	26,306	24,237
Cash, cash equivalents, and restricted cash at end of period	\$ 30,568	\$ 27,952	\$ 26,306
Supplemental disclosures			
Income taxes paid	\$ 158	\$ 216	\$ 177
Interest paid	1,188	1,019	333
Noncash investing and financing activities:			
Issuance of common stock for cashless exercise of warrants	4,500	3,000	—
Issuance of common stock for acquisition of corporate real estate	—	9,640	—
Purchases of property and equipment included in accounts payable and accrued liabilities	485	106	390
Property and equipment acquired under financing leases	\$ —	\$ —	\$ 689

Trupanion, Inc.
Notes to Consolidated Financial Statements

1. Nature of Operations and Summary of Significant Accounting Policies

Description of Business

Trupanion, Inc. (collectively with its wholly-owned subsidiaries, the "Company") provides medical insurance for cats and dogs throughout the United States, Canada and Puerto Rico. The Company believes its data-driven, vertically-integrated approach makes its subscription the highest value for pet owners, with pricing specific to each pet's unique characteristics.

Basis of Presentation

The consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP") and include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts and related disclosures. Actual results could differ from such estimates.

Reclassifications

Certain prior year amounts have been reclassified within the Company's consolidated financial statements from their original presentation to conform to the current period presentation.

Cash, Cash Equivalents and Restricted Cash

The Company considers all highly liquid investments with an original maturity of three months or less to be cash equivalents. At times, cash on deposit may be in excess of the applicable federal deposit insurance corporation limits.

The Company considers any cash account that is contractually restricted to withdrawal or use to be restricted cash. The Company is party to a financing agreement requiring a restricted cash balance. As of December 31, 2019, the Company was in compliance with all requirements.

Accounts and Other Receivables

Receivables are comprised of trade receivables and other miscellaneous receivables. Accounts and other receivables are carried at their estimated collectible amounts. Accounts receivable balance is primarily related to the Company's other business segment where the Company generates revenue from underwriting policies through unaffiliated general agents. These policies are typically annual policies, with monthly payment terms through the end of the twelve-month period. The Company had \$50.0 million and \$27.6 million accounts receivable associated with underwriting these policies as of December 31, 2019 and 2018, respectively.

Deferred Acquisition Costs

The Company incurs certain costs, including premium taxes, fees and enrollment-based bonuses, and referral fees that directly relate to the successful acquisition of new or renewal customer contracts. These costs are deferred and are included in prepaid expenses and other assets on the consolidated balance sheet and amortized over the related policy term to the applicable financial statement line item, either sales and marketing expense or other cost of revenue. Deferred acquisition costs as of December 31, 2019 and December 31, 2018 were \$1.8 million and \$1.3 million, respectively. Amortized deferred acquisition costs classified within sales and marketing amounted to \$2.5 million, \$2.1 million, and \$1.7 million and amortized deferred acquisition costs classified within other cost of revenue amounted to \$19.2 million, \$15.9 million, and \$13.2 million, for the years ended December 31, 2019, 2018, and 2017, respectively.

Investments

The Company invests in investment grade fixed income securities of varying maturities. Long-term investments are classified as available-for-sale and reported at fair value with unrealized gains and losses included in accumulated other comprehensive loss. Short-term investments are classified as held-to-maturity and reported at amortized cost. Premiums or discounts on fixed income securities are amortized or accreted over the life of the security and included in interest income. There have been no realized gains and losses on sales of fixed income securities.

The Company evaluates whether declines in the fair value of its investments below book value are other-than-temporary. This evaluation includes the Company's ability and intent to hold the security until an expected recovery occurs, the severity and duration of the unrealized loss, as well as all available information relevant to the collectability of the security, including past events, current conditions, and reasonable and supportable forecasts, when developing estimates of cash flows expected to be collected.

Fair Value of Financial Instruments

The Company is required to disclose information on all assets and liabilities reported at fair value that enables an assessment of the inputs used in determining the reported fair values. The fair value hierarchy prioritizes valuation inputs based on the observable nature of those inputs. The fair value hierarchy applies only to the valuation inputs used in determining the reported fair value of the investments and is not a measure of the investment credit quality. The hierarchy defines three levels of valuation inputs:

Level 1 - Quoted prices in active markets for identical assets or liabilities

Level 2 - Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly

Level 3 - Unobservable inputs that reflect the Company's own assumptions about the assumptions market participants would use in pricing the asset or liability

The Company's financial instruments, in addition to those presented in Note 7, Fair Value, include cash and cash equivalents, accounts receivable, accounts payable, and accrued liabilities. The carrying amounts of accounts receivable, accounts payable, and accrued liabilities approximate fair value because of the short-term nature of these instruments.

Property and Equipment

Property and equipment primarily consists of building, land and land improvements, office equipment, internally-developed software related to the Company's website, and internal support systems, capitalized during the application development stage of the project. Property and equipment is recorded at cost and depreciated using the straight-line method over the estimated useful life of the respective asset:

Land	Not depreciable
Land improvements	10 years
Building	39 years
Software	3 to 5 years
Office equipment	3 to 5 years

Intangible Assets

Acquired finite-lived intangibles are amortized on a straight-line basis over the estimated useful lives of the assets. Indefinite-lived intangible assets are not amortized. The Company reviews these assets for impairment at least annually or if indicators of potential impairment exist.

Asset Impairment

Long-lived assets, including property, equipment, and intangible assets, are reviewed for impairment when events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Should an impairment exist, the impairment loss would be measured as the amount the asset's carrying value exceeds its fair value. The Company has recognized no impairment loss on long-lived assets for the years ended December 31, 2019, 2018, and 2017.

Reserve for Veterinary Invoices

Reserve for veterinary invoices is an estimate of the future amount the Company will pay for veterinary invoices that are dated as of, or prior to, its balance sheet date. The reserve also includes the Company's estimate of related internal processing costs. To determine the accrual, the Company makes assumptions based on its historical experience, including the number of veterinary invoices it expects to receive, the average cost of those veterinary invoices, the length of time between the date of the veterinary invoice and the date the Company receives it, the member's chosen deductible, and the Company's expected cost to process and administer the payments. As of each balance sheet date, the Company reevaluates its reserve and may adjust the estimate for new information.

Deferred Revenue

Deferred revenue consists of subscription fees received or billed in advance of the subscription services within the Company's subscription business, and the unexpired term of premiums related to the Company's unaffiliated general agents within the other business segment.

Revenue Recognition

The Company generates revenue primarily from subscription fees and through underwriting policies for unaffiliated general agents. Revenue is recognized pro-rata over the terms of the customer contracts.

Veterinary Invoice Expense

Veterinary invoice expense includes the Company's costs to review veterinary invoices, administer the payments, and provide member services, and other operating expenses directly or indirectly related to this process. The Company also accrues for veterinary invoices that have been incurred but not yet received. This also includes amounts paid by unaffiliated general agents, and an estimate of amounts incurred and not yet paid for the other business segment.

Other Cost of Revenue

Other cost of revenue for the subscription business segment includes direct and indirect member service expenses, Territory Partner renewal fees, credit card transaction fees and premium tax expenses. Other cost of revenue for the other business segment includes the commissions the Company pays to unaffiliated general agents, costs to administer the programs in the other business segment and premium taxes on the sales in this segment.

Technology and Development

Technology and development expenses primarily consist of personnel costs and related expenses for the Company's technology staff, which includes information technology development and infrastructure support and third-party services, as well as depreciation of hardware and capitalized software.

General and Administrative

General and administrative expenses consist primarily of personnel costs and related expenses for the Company's finance, actuarial, human resources, legal, regulatory, and general management functions, as well as facilities and professional services.

Sales and Marketing

Sales and marketing expenses consist of costs to educate veterinarians and consumers about the benefits of Trupanion, to generate leads, and to convert leads to enrolled pets, as well as print, online and promotional advertising costs, and employee compensation and related costs.

Other (Income) Expense, Net

Other income, net, was \$1.6 million, \$1.3 million, and \$1.2 million, including interest income of \$1.7 million, \$0.9 million, and \$0.2 million for the years ended December 31, 2019, 2018, and 2017, respectively. Other income in the year ended December 31, 2017 included a gain of \$1.0 million from the sale of the Company's equity method investment.

Advertising

Advertising costs are expensed as incurred, with the exception of television advertisements, which are expensed the first time each advertisement is aired. Advertising costs amounted to \$7.8 million, \$6.3 million and \$4.9 million, in the years ended December 31, 2019, 2018 and 2017, respectively.

Stock-Based Compensation

Compensation expense related to stock-based transactions, including employee and non-employee stock option awards, restricted stock awards, and restricted stock units, is measured and recognized in the financial statements based on fair value. The fair value of restricted stock awards and restricted stock units is the common stock price as of the measurement date. The fair value of stock options is estimated on the measurement date using the Black-Scholes option-pricing model that requires management to apply judgment and make estimates, including:

- *Expected volatility*—The Company estimates the expected volatility based on the historical volatility of a representative group of publicly traded companies with similar characteristics to the Company, and its own historical volatility;
- *Expected term for awards granted to employees*—The Company has based its expected term for awards issued to employees on the simplified method, as permitted by the SEC Staff Accounting Bulletin Topic 14, Share-Based Payment;
- *Risk-free interest rate*—The risk-free interest rate is based on the yields of U.S. Treasury securities with maturities similar to the expected term of the options; and
- *Expected dividend yield*—The Company has never declared or paid any cash dividends and does not presently plan to pay cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero.

Stock-based compensation expense for stock options, restricted stock awards, and restricted stock units is recognized on a straight-line basis over the requisite service period, which is generally the vesting period of the respective award. The Company recognizes forfeitures when they occur.

Income Taxes

The Company uses the asset and liability approach for accounting and reporting income taxes. Deferred tax assets and liabilities are recognized for future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities, and their respective tax bases, operating loss, and tax credit carryforwards.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect of a tax rate change is recognized in the period that includes the enactment date. Valuation allowances are provided for when it is considered more likely than not that deferred tax assets will not be realized.

The Company recognizes the effect of income tax positions only if those positions are more likely than not of being sustained. Recognized income tax positions are measured at the largest amount that is greater than a 50% likelihood of being realized. Penalties and interest are classified as a component of income taxes.

Foreign Currency Translation

The Company's consolidated financial statements are reported in U.S. dollars. Assets and liabilities denominated in foreign currencies were translated to U.S. dollars, the reporting currency, at the exchange rates in effect on the balance sheet date. Revenue and expenses denominated in foreign currencies were translated to U.S. dollars using a weighted-average rate for the relevant reporting period. Cumulative translation adjustments of \$0.4 million, \$0.7 million, and \$0.1 million were recorded in accumulated other comprehensive loss as of December 31, 2019, 2018, and 2017, respectively.

Insurance Operations

Effective January 1, 2015, the Company formed a segregated account in Bermuda as part of Wyndham Insurance Company (SAC) Limited (WICL), and entered into a revised fronting and reinsurance arrangement with Omega General Insurance Company (Omega) to include its newly formed segregated account. The Company maintains all risk with the business written in Canada and consolidates the entity in its financial statements. Dividends are allowed subject to the Segregated Accounts Company Act of 2000, which allows for dividends only to the extent that the entity remains solvent and the value of its assets remain greater than the aggregate of its liabilities and its issued share capital and share premium accounts.

For the Company's Canadian business, all plans are written by Omega and the risk is assumed by the Company through a fronting and reinsurance agreement. Premiums are recognized and earned pro rata over the terms of the related customer contracts. Revenue recognized from the agreement in 2019, 2018, and 2017 was \$67.5 million, \$57.4 million and \$47.1 million, respectively, and deferred revenue relating to this arrangement at December 31, 2019 and 2018 was \$2.7 million and \$2.1 million, respectively. Reinsurance revenue was 18% of total revenue in 2019 and was 19% in 2018 and 2017. Cash designated for the purpose of paying claims related to this reinsurance agreement was \$4.6 million and \$3.9 million at December 31, 2019 and 2018, respectively. In addition, as required by the Office of the Superintendent of Financial institutions regulations related to the Company's reinsurance agreement with Omega, the Company is required to fund a Canadian Trust account with the greater of CAD \$2.0 million or 115% of unearned Canadian premium plus 15% of outstanding Canadian claims, including all incurred but not reported claims. As of December 31, 2019, the account balance was CAD \$4.3 million and the Company was in compliance with all requirements.

The Company has not transferred any risk to third-party reinsurers.

Concentrations of Credit Risk

Financial instruments, which potentially subject the Company to concentration of credit risk, consist primarily of cash and cash equivalents and investments. The Company manages its risk by investing cash equivalents and investment securities in money market instruments and securities of the U.S. government, U.S. government agencies and high-credit-quality issuers of debt securities.

Recently Adopted Accounting Pronouncements

The Company adopted Accounting Standards Update (ASU) No. 2016-02 Leases (Topic 842), as amended, using the modified retrospective approach under which the transition provisions were applied as of January 1, 2019. In addition, the Company elected the "package of practical expedients" under the transition guidance within the new standard to not reassess prior conclusions about lease identification, lease classification, and initial direct costs for existing lease contracts. The Company also elected the practical expedient to not separate lease and non-lease components, if any, for all lease contracts.

Upon adoption of this standard, the Company recorded approximately \$0.1 million right-of-use assets and lease liabilities for operating leases. They were classified as other long-term assets and other liabilities on the Company's consolidated balance sheets. The standard did not have a material impact on the Company's consolidated statements of operations, stockholders' equity, or cash flows.

Recent Accounting Pronouncements

In June 2016, the Financial Accounting Standards Board (FASB) issued an ASU amending the measurement of credit losses on financial instruments. The ASU requires the measurement and recognition of expected credit losses for financial assets held at amortized cost. This replaces the existing incurred loss impairment model with an expected loss methodology, which will result in more timely recognition of credit losses. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within that reporting period, with early adoption permitted. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial statements.

In August 2018, the FASB issued an ASU that eliminates certain disclosure requirements for fair value measurements, requires new disclosures regarding significant unobservable inputs used to develop Level 3 fair value measurements, and modifies certain existing disclosure requirements for Level 3 fair value measurements. This ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within that reporting period, with early adoption permitted. The Company does not expect the adoption of this standard to have a material impact on its consolidated financial statements.

2. Net Loss per Share

Basic net loss per share is computed using the weighted-average number of shares of common stock outstanding during the period. Diluted net loss per share is calculated using the weighted-average number of shares of common stock plus, when dilutive, potential common shares outstanding using the treasury-stock method. Potential common shares outstanding include stock options, unvested restricted stock awards and restricted stock units, and warrants.

The following potentially dilutive equity securities were not included in the diluted earnings per common share calculation because they would have had an antidilutive effect:

	As of December 31,		
	2019	2018	2017
Stock options	2,097,978	2,621,503	4,006,399
Restricted stock awards and restricted stock units	581,943	451,160	256,842
Warrants	—	480,000	810,000

3. Property and Equipment, Net

Property and equipment, net consisted of the following (in thousands):

	December 31,	
	2019	2018
Land and improvements	\$ 15,854	\$ 15,833
Building and improvements	47,558	46,561
Software	22,976	20,338
Office equipment and other	3,384	2,772
Construction in progress	247	—
Property and equipment, at cost	90,019	85,504
Less: Accumulated depreciation	(19,647)	(15,701)
Property and equipment, net	\$ 70,372	\$ 69,803

Depreciation expense related to property and equipment was \$4.7 million, \$4.3 million and \$4.2 million for the years ended December 31, 2019, 2018 and 2017, respectively.

Acquisition of Real Estate

In August 2018, the Company purchased a real property that houses the company headquarters located at 6100 Fourth Avenue South, Seattle, Washington. The real estate acquisition was determined to be an asset acquisition, with the purchase price allocated based on relative fair value of the assets acquired. Additionally, acquisition-related expenses were capitalized as part of the purchase price. The purchase price was \$65.2 million, consisting of \$55.0 million in cash, 303,030 shares of common stock with an estimated fair value of \$9.6 million, and transaction costs totaling \$0.6 million. The issued shares are subject to a lock-up period that continues to and includes June 25, 2020. The fair value of the issued shares was estimated as of the closing date for the real estate acquisition using the Black-Scholes option pricing model and the following assumptions:

Assumptions	August 9, 2018
	Fair Value
Risk free interest rate	2.5%
Expected volatility	36.72%
Expected life (years)	1.88
Expected dividend yield	—%

The purchase price was allocated to the following assets based on estimates of their relative fair value (in thousands):

Building and improvements	\$	46,379
Land and improvements		15,833
Lease-related intangible assets		2,959
Total purchase price	\$	65,171

The Company assessed fair value on the date of the acquisition based on Level 3 inputs within the fair value framework, which included estimated cash flow projections that utilized appropriate discount rates, capitalization rates, renewal probability and available market information, which included market rental rates and market rent growth rates. Estimates of future cash flows were based on a number of factors including historical operating results, known and anticipated trends, and market and economic conditions.

The fair value of tangible assets of the acquired property considers the value of the property as if it were vacant. The fair value of acquired “above- and below-” market leases was based on the estimated cash flow projections utilizing discount rates that reflected the risks associated with the leases acquired. The amount recorded was based on the present value of the difference between (i) the contractual amounts to be paid pursuant to each in-place lease and (ii) management’s estimate of fair market lease rates for each in-place lease, measured over a period equal to the remaining term of the lease for above-market leases and the initial term plus the extended term for any leases with below-market renewal options. Other intangible assets acquired included amounts for in-place lease values that were based on the Company’s evaluation of the specific characteristics of each tenant’s lease. Factors considered include estimates of carrying costs during hypothetical expected lease-up periods, market conditions and costs to execute similar leases. In estimating carrying costs, the Company included estimates of lost rents at market rates during the hypothetical expected lease-up periods, which were dependent on local market conditions. In estimating costs to execute similar leases, the Company considered leasing commissions, legal and other related costs.

The results of operations related to our ownership of the building are included in the Company’s consolidated statements of operations from the date of acquisition.

4. Intangible Assets, Net

The following table presents the detail of intangible assets for the periods presented (in thousands):

	Gross Carrying Value	Accumulated Amortization	Net Carrying Value
December 31, 2019:			
Licenses	\$ 4,773	\$ —	\$ 4,773
Leases	2,959	(1,084)	1,875
Patents, trademarks, and other	1,287	(204)	1,083
Total Intangibles	<u>\$ 9,019</u>	<u>\$ (1,288)</u>	<u>\$ 7,731</u>
December 31, 2018:			
Licenses	\$ 4,773	\$ —	\$ 4,773
Leases	2,959	(213)	2,746
Patents, trademarks, and other	743	(191)	552
Total Intangibles	<u>\$ 8,475</u>	<u>\$ (404)</u>	<u>\$ 8,071</u>

The Company acquired an insurance company in 2007, which originally included licenses in 23 states. These licenses were valued at \$4.8 million. The Company is currently licensed in all 50 states, the District of Columbia and Puerto Rico. Most licenses are renewed annually upon payment of various fees assessed by the issuing state. Renewal costs are expensed as incurred. This is considered an indefinite-lived intangible asset given the planned renewal of the certificates of authority and applicable licenses for the foreseeable future.

The lease-related intangible assets relate to in-place lease agreements associated with the building acquisition in August 2018 and have a remaining weighted-average useful life of 3.4 years. Patents, trademarks, and other intangible assets have a remaining weighted-average useful life of 9.9 years.

Amortization expense associated with intangible assets was \$0.9 million and \$0.2 million for the years ended December 31, 2019 and 2018, respectively. There was no amortization expense associated with intangible assets in 2017.

As of December 31, 2019, expected amortization expense relating to purchased intangible assets for each of the next five years and thereafter is as follows (in thousands):

Year ending December 31:

2020	\$	949
2021		714
2022		245
2023		245
2024		245
Thereafter		493
Total	\$	<u>2,891</u>

5. Investments

The amortized cost, gross unrealized holding gains and losses, and fair value of long-term and short-term investments by major security type and class of security were as follows as of December 31, 2019 and 2018 (in thousands):

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
As of December 31, 2019				
Long-term investments:				
Foreign deposits	\$ 3,323	\$ —	\$ —	\$ 3,323
Municipal bond	1,000	—	—	1,000
	<u>\$ 4,323</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 4,323</u>
Short-term investments:				
U.S. Treasury securities	\$ 6,156	\$ —	\$ (1)	\$ 6,155
Certificates of deposit	440	—	—	440
U.S. government funds	63,136	—	—	63,136
	<u>\$ 69,732</u>	<u>\$ —</u>	<u>\$ (1)</u>	<u>\$ 69,731</u>
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
As of December 31, 2018				
Long-term investments:				
Foreign deposits	\$ 2,573	\$ —	\$ —	\$ 2,573
Municipal bond	1,000	—	(19)	981
	<u>\$ 3,573</u>	<u>\$ —</u>	<u>\$ (19)</u>	<u>\$ 3,554</u>
Short-term investments:				
U.S. Treasury securities	\$ 6,645	\$ —	\$ (3)	\$ 6,642
Certificates of deposit	437	—	—	437
U.S. government funds	47,477	—	—	47,477
	<u>\$ 54,559</u>	<u>\$ —</u>	<u>\$ (3)</u>	<u>\$ 54,556</u>

Maturities of debt securities classified as available-for-sale were as follows (in thousands):

	December 31, 2019	
	Amortized Cost	Fair Value
Available-for-sale:		
Due after one year through five years	\$ 4,323	\$ 4,323
	<u>\$ 4,323</u>	<u>\$ 4,323</u>

The Company evaluated its securities for other-than-temporary impairment and considers the decline in market value for the securities to be primarily attributable to current economic and market conditions. For debt securities, the Company does not intend to sell, nor is it more likely than not that the Company will be required to sell, the securities prior to maturity or prior to the recovery of the amortized cost basis.

6. Other Investments

Investment in Variable Interest Entity

In July 2018, the Company purchased \$3.0 million in preferred stock of a privately held corporation with a complementary business line. The Company does not have power over the activities that most significantly impact the economic performance of this variable interest entity and is, therefore, not the primary beneficiary. In October 2019, the Company purchased an additional \$4.0 million in preferred stock upon the exercise of an option by the variable interest entity. The Company has an option to purchase all the outstanding common shares issued by the variable interest entity on the fifth anniversary of the initial preferred stock purchase.

Additionally, the Company has extended a \$2.5 million revolving line of credit to the variable interest entity to fund its inventory purchases. The Company's investment and amounts loaned under the line of credit are recorded in other long-term assets on the consolidated balance sheet. Outstanding loan balance under the line of credit was \$2.5 million and \$0.6 million as of December 31, 2019 and 2018, respectively. The Company has also entered into a series of agreements to provide ancillary services to the variable interest entity at cost. The Company provided \$1.4 million and \$0.6 million of these services for the years ended December 31, 2019 and 2018, respectively, which were recorded against its operating expenses.

Investment in Joint Venture

In September 2018, the Company acquired a non-controlling equity interest in a joint venture, whereby it has committed to licensing certain intellectual property and contributing up to \$2.2 million AUD upon the achievement of specific operational milestones over a period of at least four years from the agreement execution date. As of December 31, 2019, the Company has contributed \$0.5 million AUD. This equity investment is accounted for using the equity method and is classified in other long-term assets on the Company's consolidated balance sheet. The Company's share of income and losses from this equity method investment is included in gain (loss) from investment in joint venture on its consolidated statement of operations. Also included in this line item are income and expenses associated with administrative services provided to the joint venture.

7. Fair Value

The following table summarizes, by major security type, the Company's assets that are measured at fair value on a recurring basis, and placement within the fair value hierarchy (in thousands):

	As of December 31, 2019			
	Fair Value	Level 1	Level 2	Level 3
Assets				
Restricted cash	\$ 1,400	\$ 1,400	\$ —	\$ —
Money market funds	1,050	1,050	—	—
Fixed maturities:				
Foreign deposits	3,323	3,323	—	—
Municipal bond	1,000	—	1,000	—
Investment in variable interest entity	7,625	—	—	7,625
Total	<u>\$ 14,398</u>	<u>\$ 5,773</u>	<u>\$ 1,000</u>	<u>\$ 7,625</u>

	As of December 31, 2018			
	Fair Value	Level 1	Level 2	Level 3
Assets				
Restricted cash	\$ 1,400	\$ 1,400	\$ —	\$ —
Money market funds	2,010	2,010	—	—
Fixed maturities:				
Foreign deposits	2,573	2,573	—	—
Municipal bond	981	—	981	—
Investment in variable interest entity	3,000	—	—	3,000
Total	<u>\$ 9,964</u>	<u>\$ 5,983</u>	<u>\$ 981</u>	<u>\$ 3,000</u>

The Company measures the fair value of restricted cash, money market funds, and foreign deposits based on quoted prices in active markets for identical assets. The fair value of the municipal bond is based on either recent trades in inactive markets or quoted market prices of similar instruments and other significant inputs derived from or corroborated by observable market data. Short-term investments are carried at amortized cost and the fair value is disclosed in Note 5, Investments. The fair value of these investments is determined in the same manner as for available-for-sale securities and is considered a Level 1 measurement.

The Company purchased \$4.0 million and \$3.0 million in preferred stock in the variable interest entity for the year ended December 31, 2019 and 2018, respectively. The preferred stock investment is accounted for as an available-for-sale debt security, and measured at fair value at each balance sheet date. The estimated fair value of the preferred stock investment is a Level 3 measurement, and is based on certain unobservable inputs such as the value of the underlying enterprise, volatility, time to liquidity, and market interest rates. An increase or decrease in any of these unobservable inputs would result in a change in the fair value measurement. Fair value was \$7.6 million and \$3.0 million as of December 31, 2019 and 2018, respectively. The Company recognized a \$0.6 million unrealized gain in other comprehensive income (loss) for the year ended December 31, 2019.

Fair Value Disclosures

The Company's other long-term assets balance included notes receivable of \$6.1 million and \$3.0 million as of December 31, 2019 and 2018, respectively, recorded at their estimated collectible amount. The Company estimates that the carrying value of the notes receivable approximates the fair value. The estimated fair value represents a Level 3 measurement within the fair value hierarchy, and is based on market interest rates and the assessed creditworthiness of the third party.

The Company estimates the fair value of long-term debt based upon rates currently available to the Company for debt with similar terms and remaining maturities. This is a Level 3 measurement. Based upon the terms of the debt, the carrying amount of long-term debt approximated fair value at December 31, 2019 and December 31, 2018.

The Company recognizes transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no transfers between levels for the year ended December 31, 2019 and 2018.

8. Commitments and Contingencies

The following summarizes the Company's contractual commitments as of December 31, 2019 (in thousands):

	Year Ending December 31,						Total
	2020	2021	2022	2023	2024	Thereafter	
Long-term debt obligations ⁽¹⁾	\$ —	\$ —	\$ 26,200	\$ —	\$ —	\$ —	\$ 26,200
Lease obligations	40	40	10	—	—	—	90
Other obligations ⁽²⁾	3,320	1,053	520	237	168	2,296	7,594
Total	\$ 3,360	\$ 1,093	\$ 26,730	\$ 237	\$ 168	\$ 2,296	\$ 33,884

(1) Consists of a revolving line of credit. Excludes interest of the greater of 4.5% or 0.75% plus the prime rate (5.50% as of December 31, 2019).

(2) Consists of contractual obligations from non-cancellable vendor service agreements.

Legal Proceedings

Certain state insurance regulators in the United States have contacted the Company regarding whether employees who had helped prospective members enroll by telephone in prior years were required to have an insurance license to conduct such telephone conversations. To date, the Company has resolved each of these matters in non-material amounts and believes it is compliant with the applicable regulations. The Company is currently engaged with a limited number of state insurance regulators to resolve this same legacy issue and believes it has adequately reserved for these matters.

In addition, from time to time the Company is or may become subject to various legal proceedings arising in the ordinary course of business, including proceedings against members, other entities or regulatory bodies. Estimated liabilities are recorded when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. At this time, the Company does not believe any such matters to be material individually or in the aggregate. These views are subject to change following the outcome of future events or the results of future developments.

9. Reserve for Veterinary Invoices

The reserve for veterinary invoices is an estimate of the future amount the Company will pay for veterinary invoices that are dated as of, or prior to, its balance sheet date. The reserve also includes the Company's estimate of related internal processing costs. The reserve estimate involves actuarial projections, and is based on management's assessment of facts and circumstances currently known, and assumptions about anticipated patterns. The reserve is made for each of the Company's segments, subscription and other business, and are continually refined as the Company receives and pays veterinary invoices. Changes in management's assumptions and estimates may have a relatively large impact to the reserve and associated expense.

Reserve for veterinary invoices

Summarized below are the changes in the total liability for the Company's subscription business segment (in thousands):

Subscription	Year Ended December 31,		
	2019	2018	2017
Reserve at beginning of year	\$ 13,875	\$ 11,059	\$ 8,538
Veterinary invoice expense during the period related to:			
Current year	231,831	190,642	155,623
Prior years	585	409	(69)
Total veterinary invoice expense	232,416	191,051	155,554
Amounts paid during the period related to:			
Current year	217,538	177,418	144,802
Prior years	12,494	10,130	7,777
Total paid	230,032	187,548	152,579
Non-cash expenses	718	687	454
Reserve at end of period	\$ 15,541	\$ 13,875	\$ 11,059

The Company's reserve for the subscription business segment increased \$1.6 million from \$13.9 million at December 31, 2018 to \$15.5 million at December 31, 2019. This change was comprised of \$232.4 million in expense recorded during the period less \$230.0 million in payments of veterinary invoices. This \$232.4 million in veterinary invoice expense incurred included an increase of \$0.6 million to the reserves relating to prior years, which was the result of ongoing analysis of recent payment trends. The Company's adjustments to prior year reserves were an increase of \$0.4 million and a reduction of \$0.1 million as a result of analysis of payment trends in the years ended December 31, 2018 and 2017, respectively.

Summarized below are the changes in total liability for the Company's other business segment (in thousands):

Other Business	Year Ended December 31,		
	2019	2018	2017
Reserve at beginning of year	\$ 2,187	\$ 1,697	\$ 983
Veterinary invoice expense during the period related to:			
Current year	38,881	23,784	14,739
Prior years	(350)	(296)	(171)
Total veterinary invoice expense	38,531	23,488	14,568
Amounts paid during the period related to:			
Current year	33,254	21,615	13,053
Prior years	1,811	1,383	801
Total paid	35,065	22,998	13,854
Non-cash expenses	—	—	—
Reserve at end of period	\$ 5,653	\$ 2,187	\$ 1,697

The Company's reserve for the other business segment increased \$3.5 million from \$2.2 million at December 31, 2018 to \$5.7 million at December 31, 2019. This change was comprised of \$38.5 million in expense recorded during the period less \$35.1 million in payments of veterinary invoices. This \$38.5 million in veterinary invoice expense incurred included a reduction of \$0.4 million to the reserves relating to prior years, which was the result of ongoing analysis of recent payment trends. The Company's adjustments to decrease prior year reserves were \$0.3 million and \$0.2 million as a result of analysis of payment trends in each of the years ended December 31, 2018 and 2017, respectively.

Veterinary invoice expenses

In the following tables, the cumulative number of veterinary invoices represents the total number received as of December 31, 2019, by year the veterinary invoice relates to, referred to as the year of occurrence. If a pet is injured or becomes ill, multiple trips to the veterinarian may result in several invoices. Each of these veterinary invoices is included in the cumulative number, regardless of whether the veterinary invoice was paid. Information for years 2016 through 2018 is provided as required supplementary information. Amounts in these tables are presented on a constant currency basis to remove the impact of changes in the foreign currency exchange rate on development. The cumulative expenses as of the end of each year are revalued using the currency exchange rate as of December 31, 2019.

The following table summarizes the development of veterinary invoice expense, on a constant currency basis, for the Company's subscription business segment by year of occurrence (in thousands, except for cumulative number of veterinary invoices data):

Subscription	Cumulative veterinary invoice expenses				Reserve	Cumulative number of veterinary invoices
	As of December 31,				As of December 31,	
	2016	2017	2018	2019	2019	2019
Year of Occurrence	<i>(unaudited)</i>	<i>(unaudited)</i>	<i>(unaudited)</i>			
2016	\$ 124,169	\$ 123,954	\$ 124,035	\$ 124,040	\$ 137	600,143
2017		\$ 155,398	\$ 155,678	\$ 155,681	\$ 464	725,796
2018			\$ 190,316	\$ 190,804	\$ 1,365	870,806
2019				\$ 232,552	\$ 13,575	965,768
				<u>\$ 703,077</u>	<u>\$ 15,541</u>	

The following table summarizes the development of veterinary invoice expense, on a constant currency basis, for the Company's other business segment by year of occurrence (in thousands, except for cumulative number of veterinary invoices data):

Other Business	Cumulative veterinary invoice expenses				Reserve	Cumulative number of veterinary invoices
	As of December 31,				As of December 31,	
	2016	2017	2018	2019	2019	2019
Year of Occurrence	(unaudited)	(unaudited)	(unaudited)			
2016	\$ 9,027	\$ 8,843	\$ 8,855	\$ 8,862	\$ 1	59,665
2017		\$ 14,738	\$ 14,420	\$ 14,471	\$ 5	105,891
2018			\$ 23,782	\$ 23,371	\$ 20	173,778
2019				\$ 38,883	\$ 5,627	262,083
				<u>\$ 85,587</u>	<u>\$ 5,653</u>	

Cumulative paid veterinary invoice expense

In the following tables, amounts are by year the veterinary invoice relates to, referred to as the year of occurrence. Amounts in these tables are presented on a constant currency basis to remove the impact of changes in the foreign currency exchange rate. The cumulative amounts paid as of the end of each year are revalued using the currency exchange rate as of December 31, 2019. Information for years 2016 through 2018 is provided as required supplementary information.

The following table summarizes the amounts paid for veterinary invoices, inclusive of related internal processing costs and reported on a constant currency basis, for the subscription segment (in thousands):

Subscription	Year Ended December 31,			
	2016	2017	2018	2019
Year of Occurrence	(unaudited)	(unaudited)	(unaudited)	
2016	\$ 115,965	\$ 123,422	\$ 123,764	\$ 123,902
2017		\$ 145,087	\$ 154,679	\$ 155,217
2018			\$ 177,714	\$ 189,439
2019				\$ 218,977
				<u>\$ 687,535</u>
Total amounts unpaid and recorded as a liability				\$ 15,541

The following table summarizes the amounts paid for veterinary invoices, inclusive of related internal processing costs and reported on a constant currency basis, for the other business segment (in thousands):

Other Business	Year Ended December 31,			
	2016	2017	2018	2019
Year of Occurrence	(unaudited)	(unaudited)	(unaudited)	
2016	\$ 8,048	\$ 8,832	\$ 8,852	\$ 8,861
2017		\$ 13,053	\$ 14,408	\$ 14,466
2018			\$ 21,613	\$ 23,351
2019				\$ 33,256
				<u>\$ 79,934</u>
Total amounts unpaid and recorded as a liability				\$ 5,653

10. Debt

The Company has a revolving line of credit of up to \$50.0 million, maturing in June 2022. The facility is secured by any and all interests in the Company's assets that are not otherwise restricted. Interest on the revolving line of credit is payable monthly at the greater of 4.5% or 0.75% plus the prime rate (5.50% at December 31, 2019). The credit agreement includes other ancillary services and letters of credit of up to \$4.5 million. It also requires a deposit of restricted cash of \$1.4 million and a minimum cash or investment balance of \$2.1 million. The credit agreement requires the Company to comply with various financial and non-financial covenants. As of December 31, 2019, the Company was in compliance with all financial and non-financial covenants required by the credit agreement.

Borrowings on the revolving line of credit were limited to the lesser of \$50.0 million or the total amount of cash and securities held by the Company's insurance subsidiaries (American Pet Insurance Company and Wyndham Insurance Company (SAC) Limited Segregated Account AX), less amounts outstanding relating to other ancillary services and letters of credit. As of December 31, 2019, available borrowing capacity on the line of credit was \$23.3 million, with an outstanding balance of \$0.5 million for ancillary services and letters of credit, and borrowings under the facility of \$26.2 million, recorded net of financing fees of \$0.1 million.

11. Stock-Based Compensation

Stock-based compensation expense includes stock options, restricted stock awards, and restricted stock units granted to employees and non-employees and has been reported in the Company's consolidated statements of operations depending on the function performed by the employee or non-employee. Stock-based compensation expense recognized in each category of the consolidated statement of operations for the years ended December 31, 2019, 2018 and 2017 was as follows (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Veterinary invoice expense	\$ 697	\$ 571	\$ 355
Other cost of revenue	353	356	239
Technology and development	364	209	216
General and administrative	3,312	2,304	1,887
Sales and marketing	2,120	1,335	722
Total expensed stock-based compensation	6,846	4,775	3,419
Capitalized stock-based compensation	204	175	143
Total stock-based compensation	\$ 7,050	\$ 4,950	\$ 3,562

As of December 31, 2019, the Company had 206,387 unvested stock options and 581,943 unvested restricted stock awards and restricted stock units. Total stock-based compensation expense of \$1.4 million related to unvested stock options and \$14.6 million related to unvested restricted stock awards and restricted stock units is expected to be recognized over a weighted-average period of approximately 1.1 years and 3.0 years, respectively.

Stock Options

The grant date fair value of stock option awards are estimated on the date of grant using the Black-Scholes option-pricing model. The Company did not grant any stock options during the years ended December 31, 2019 and 2018. For the year ended December 31, 2017, valuation assumptions are presented in the following table:

	Year Ended December 31,
	2017
Valuation assumptions:	
Expected term (in years)	6.25
Expected volatility	37.1%-39.8%
Risk-free interest rate	1.8%-2.2%
Expected dividend yield	—%

The following table presents information regarding stock options granted, exercised and forfeited for the periods presented:

	Number of Options	Weighted Average Exercise Price per Share	Aggregate Intrinsic Value (in thousands)
Outstanding as of January 1, 2017	4,123,023	\$ 5.06	\$ 43,185
Granted	657,339	17.74	—
Exercised	(670,823)	3.80	10,392
Forfeited	(103,140)	12.25	—
Outstanding as of December 31, 2017	4,006,399	7.16	88,578
Granted	—	—	—
Exercised	(1,292,037)	2.82	36,625
Forfeited	(92,859)	15.36	—
Outstanding as of December 31, 2018	2,621,503	9.01	43,136
Granted	—	—	—
Exercised	(510,268)	5.28	13,151
Forfeited	(13,257)	18.23	—
Outstanding as of December 31, 2019	2,097,978	9.86	57,907
Exercisable at December 31, 2019	1,891,591	\$ 9.04	\$ 53,760

As of December 31, 2019, stock options outstanding and stock options exercisable had a weighted average remaining contractual life of 5.1 years and 4.8 years, respectively.

The weighted-average grant date fair value per share and the fair value of options vested were as follows for the years ended December 31, 2019, 2018, and 2017:

Year:	Weighted Average Grant Date Fair Value per Share	Fair Value of Options Vested (in thousands)
2017	\$ 7.25	\$ 6,313
2018	\$ —	\$ 2,665
2019	\$ —	\$ 1,591

Restricted Stock Awards and Restricted Stock Units

The below table summarizes the Company's restricted stock award and restricted stock unit activity for the years ended December 31, 2019, 2018 and 2017:

	Number of Shares	Weighted Average Grant Date Fair Value per Share
Unvested shares as of January 1, 2017	350,631	\$ 4.77
Granted	23,659	30.19
Vested	(116,877)	4.77
Forfeited	(571)	30.19
Unvested shares as of December 31, 2017	256,842	4.77
Granted	375,313	28.10
Vested	(149,213)	9.74
Forfeited	(31,782)	28.57
Unvested shares as of December 31, 2018	451,160	22.16
Granted	459,523	30.03
Vested	(276,184)	18.20
Forfeited	(52,556)	29.85
Unvested shares as of December 31, 2019	581,943	\$ 29.56

12. Leases

The Company leases certain office space and equipment from third parties and recognizes lease expense on a straight-line basis over the lease term. Leases with an initial term of 12 months or less are not recorded on its consolidated balance sheets. Minimum rent payments under operating leases are recognized on a straight-line basis over the term of the lease. Rental expense for operating leases was \$0.4 million, \$1.4 million and \$1.8 million for the years ended December 31, 2019, 2018 and 2017, respectively.

The Company also leases a portion of its building acquired in August 2018 to third parties and records related rental income within general and administrative expense in the consolidated statements of operations. These leases have remaining initial lease terms of 2 years to 8 years, some of which give the tenants options to renew the leases for up to an additional 10 years, and options to terminate the leases after 3 years of the initial lease terms, with early termination fees required. The Company recorded rental income of \$2.2 million and \$0.9 million for the years ended December 31, 2019 and December 31, 2018, respectively.

The following table summarizes the Company's future rental payments to be received from non-cancellable leases in place as of December 31, 2019 (in thousands):

Year ending December 31:	
2020	\$ 2,002
2021	1,632
2022	1,325
2023	1,367
2024	1,410
Thereafter	1,800
Total rental payments	<u>\$ 9,536</u>

13. Stockholders' Equity

Common Stock and Preferred Stock

As of December 31, 2019, the Company had 100,000,000 shares of common stock authorized and 34,947,017 shares of common stock outstanding. Holders of common stock are entitled to one vote on each matter properly submitted to the stockholders of the Company except those related to matters concerning possible outstanding preferred stock. At December 31, 2019, the Company had 10,000,000 shares of undesignated shares of preferred stock authorized for future issuance and did not have any outstanding shares of preferred stock. The holders of common stock are also entitled to receive dividends as and when declared by the board of directors of the Company, whenever funds are legally available. These rights are subordinate to the dividend rights of holders of all classes of stock outstanding at the time. The Company is unable to pay dividends to stockholders as of December 31, 2019 due to restrictions in its credit agreements.

Follow-on Common Stock Offering

In June 2018, the Company completed a follow-on public offering (the June 2018 follow-on public offering) whereby the Company sold 2,090,909 shares of common stock at a price to the public of \$33.00 per share. The Company received aggregate net proceeds from the June 2018 follow-on public offering of \$65.7 million, after deducting underwriting discounts and commissions and offering expenses payable by the Company. The proceeds were primarily used to purchase real estate consisting of properties in use as the Company's home office. In addition, in August 2018, the Company issued 303,030 shares of common stock via a private placement to an accredited investor as a portion of the purchase price of the real estate. See Note 3, Property and Equipment.

Warrants

During the year ended December 31, 2019, 480,000 of the Company's outstanding warrants were exercised. As of December 31, 2019, no warrants remained outstanding.

Share Repurchase Program

In November 2019, the Company's board of directors authorized a share repurchase program, pursuant to which the Company may repurchase up to \$15.0 million of its outstanding shares over the next 12 months. The Company did not repurchase shares during the year ended December 31, 2019.

14. Segments

The Company has two segments: subscription business and other business. The subscription business segment includes monthly subscription fees related to the Company's medical insurance which is marketed directly to consumers, while the other business segment includes all other business that is not directly marketed to consumers.

The chief operating decision maker reviews revenue, gross profit, and operating income (loss) to evaluate segment performance. Revenue, veterinary invoice expense, other cost of revenue, and sales and marketing expenses are generally directly attributed to each segment. Other operating expenses, such as technology and development expense and general and administrative expense, are allocated proportionately based on revenue in each segment. Interest and other expenses and income taxes are not allocated to the segments, nor included in the measure of segment profit or loss. The Company does not analyze discrete segment balance sheet information related to long-term assets.

Operating income (loss) of the Company's segments were as follows (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Subscription business:			
Revenue	\$ 321,163	\$ 263,738	\$ 218,354
Veterinary invoice expense	232,415	191,051	155,554
Other cost of revenue	29,724	24,941	21,329
Gross profit	59,024	47,746	41,471
Technology and development	8,427	8,024	8,789
General and administrative	17,539	15,761	15,135
Sales and marketing	35,037	24,622	18,886
Subscription business operating income (loss)	(1,979)	(661)	(1,339)
Other business:			
Revenue	62,773	40,218	24,313
Veterinary invoice expense	38,532	23,488	14,568
Other cost of revenue	18,341	13,110	8,166
Gross profit	5,900	3,620	1,579
Technology and development	1,647	1,224	979
General and administrative	3,428	2,403	1,685
Sales and marketing	414	377	218
Other business operating income (loss)	411	(384)	(1,303)
Gain (loss) from investment in joint venture	(352)	—	—
Total operating income (loss)	\$ (1,920)	\$ (1,045)	\$ (2,642)

The following table presents the Company's revenue by geographic region of the member (in thousands):

	Year Ended December 31,		
	2019	2018	2017
United States	\$ 316,138	\$ 246,280	\$ 195,297
Canada	67,798	57,676	47,370
Total revenue	\$ 383,936	\$ 303,956	\$ 242,667

Substantially all of the Company's long-lived assets were located in the United States as of December 31, 2019 and 2018.

15. Dividend Restrictions and Statutory Surplus

The Company's business operations are conducted through subsidiaries, one of which is an insurance company domiciled in New York, American Pet Insurance Company, and one of which is a segregated cell business, Wyndham Segregated Account AX, located in Bermuda. In addition to general state law restrictions on payments of dividends and other distributions to stockholders applicable to all corporations, insurance companies are subject to further regulations that, among other things, may require such companies to maintain certain levels of equity and restrict the amount of dividends and other distributions that may be paid to their parent corporations.

New York law restricts the ability of the Company's insurance subsidiary in New York to pay dividends to its holding company parent. These restrictions are based in part on the prior year's statutory income and surplus. In general, dividends up to specified levels are considered ordinary and may be paid without prior approval, and dividends in larger amounts, or extraordinary dividends, are subject to approval by the New York State Department of Financial Services, the subsidiary's primary regulator. An extraordinary dividend or distribution is defined as a dividend or distribution that, in the aggregate in any 12-month period, exceeds the lesser of (i) 10% of surplus as of the preceding December 31 or (ii) the insurer's adjusted net investment income for such 12-month period, not including realized capital gains. Under regulatory requirements at December 31, 2019, the amount of dividends that may be paid by the Company's insurance subsidiary in New York to the Company without prior approval by regulatory authorities was \$1.5 million. This insurance subsidiary did not pay dividends to the Company during the years ended December 31, 2019, 2018, and 2017.

The Company's insurance subsidiary in Bermuda is regulated by the Bermuda Monetary Authority. Under the Bermuda Companies Act of 1981, as amended, a Bermuda company may not declare or pay a dividend or make a distribution out of contributed surplus if there are reasonable grounds for believing that: (a) the company is, or would be after the payment, unable to pay its liabilities as they become due; or (b) the realizable value of the company's assets would thereby be less than its liabilities. The Segregated Accounts Company Act of 2000 further requires that dividends out of a segregated account can only be paid to the extent that the cell remains solvent. The value of its assets must remain greater than the aggregate of its liabilities, issued share capital, and share premium accounts. Per our contractual agreements with Wyndham Insurance Company (SAC) Limited, the allowable dividend is equivalent to the positive undistributed profit attributable to the shares. This insurance subsidiary paid the Company a dividend of \$3.9 million, \$2.2 million, and \$2.7 million during the years ended December 31, 2019, 2018 and 2017, respectfully.

The statutory net income for 2019, 2018 and 2017 and statutory capital and surplus at December 31, 2019, 2018 and 2017, for the Company's insurance subsidiary in New York were as follows (in thousands):

	As of December 31,		
	2019	2018	2017
Statutory net income	\$ 16,311	\$ 11,021	\$ 7,507
Statutory capital and surplus	\$ 73,810	\$ 56,244	\$ 37,190

As of December 31, 2019, the Company's insurance subsidiary in New York maintained \$73.8 million of statutory capital and surplus which was above the required amount of \$55.3 million of statutory capital and surplus to avoid additional regulatory oversight.

As of December 31, 2019, the Company had \$6.7 million on deposit with various states in which it writes policies.

16. Income Taxes

Loss before income taxes was as follows for the years ended December 31, 2019, 2018 and 2017 (in thousands):

	Year Ended December 31,		
	2019	2018	2017
United States	\$ (1,783)	\$ (1,054)	\$ (1,965)
Foreign	143	120	34
	<u>\$ (1,640)</u>	<u>\$ (934)</u>	<u>\$ (1,931)</u>

The components of income tax expense (benefit) were as follows (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Current:			
U.S. federal & state	\$ 12	\$ (10)	\$ 183
Foreign	52	37	15
	64	27	198
Deferred:			
U.S. federal & state	116	(32)	(620)
Foreign	(11)	(2)	(6)
	105	(34)	(626)
Income tax expense (benefit)	<u>\$ 169</u>	<u>\$ (7)</u>	<u>\$ (428)</u>

On December 22, 2017, the Tax Cuts and Jobs Act of 2017 (the "Tax Act") was signed into law making significant changes to the Internal Revenue Code, including, but not limited to, a corporate tax rate decrease to 21% effective January 1, 2018. In accordance with Staff Accounting Bulletin No. 118 ("SAB 118"), the Company recorded a \$0.6 million income tax benefit in the year ended December 31, 2017 in relation to the remeasurement of its deferred tax liabilities.

A reconciliation of income tax expense at the statutory federal income tax rate and income taxes as reflected in the financial statements is presented below:

	Year Ended December 31,		
	2019	2018	2017
Federal income taxes at statutory rate	21.0 %	21.0%	34.0%
U.S. state income taxes	(7.8)	4.6	(9.5)
Equity compensation	177.2	828.5	189.1
Change in valuation allowance	(184.2)	(857.4)	(229.6)
Meals and entertainment	(4.9)	(5.4)	(3.0)
Nondeductible fines and settlements	(9.2)	(2.1)	—
Other, net	(11.6)	(8.6)	2.0
Change in federal tax rate	—	—	32.1
Credits	9.2	20.2	7.1
Effective income tax rate	<u>(10.3)%</u>	<u>0.8%</u>	<u>22.2%</u>

The principal components of the Company's deferred tax assets and liabilities were as follows (in thousands):

	Year Ended December 31,	
	2019	2018
Deferred tax assets:		
Deferred revenue	\$ 2,219	\$ 1,371
Accruals and reserves	885	475
Net operating loss carryforwards	30,569	26,566
Depreciation and amortization	240	346
Equity compensation	2,102	1,690
Credits	547	397
Other	243	430
Total deferred tax assets	36,805	31,275
Deferred tax liabilities:		
Deferred costs	(398)	(279)
Intangible assets	(1,117)	(1,002)
Other	(775)	(250)
Total deferred tax liabilities	(2,290)	(1,531)
Total deferred taxes	34,515	29,744
Less deferred tax asset valuation allowance	(35,609)	(30,701)
Net deferred tax liability	\$ (1,094)	\$ (957)

At December 31, 2019, the Company had U.S. federal and state net operating loss carryforwards of \$30.6 million (tax-effected) and U.S. federal income tax credits of \$0.5 million. Use of carryforwards is limited based on the future income of the Company. The federal net operating loss carryforwards will begin to expire in 2027. Pursuant to Sections 382 and 383 of the Internal Revenue Code, annual use of the Company's net operating loss carryforwards and credit carryforwards may be limited if the Company experiences an ownership change. As of December 31, 2019, the utilization of approximately \$0.5 million of net operating losses are subject to limitation as a result of prior ownership changes; however, subsequent ownership changes may further affect the limitation in future years.

A valuation allowance is required to reduce the deferred tax assets reported if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. After consideration of all the evidence, both positive and negative, the Company has recorded a full valuation allowance against its U.S. Federal deferred tax assets as of December 31, 2019 and 2018 because the Company's management has determined that it is more likely than not that these assets will not be fully realized.

For the year ended December 31, 2019, the Company recognized a net increase of \$4.9 million in valuation allowance against its net deferred tax assets associated with U.S. federal and certain state jurisdictions, primarily attributable to current year activity.

The Company is open to examination by the U.S. federal tax jurisdiction for the years ended December 31, 2016 through 2019. The Company is also open to examination for 2007 and forward with respect to net operating loss carryforwards generated and carried forward from those years in the United States. The Company is open to examination by the Canada Revenue Agency for the years ended December 31, 2015 through 2019 for all corporate tax matters, and open for the years ended December 31, 2012 through 2019 for transactions with non-arm's length non-Canadian residents.

For the year ended December 31, 2019, the Company considers its foreign earnings to be indefinitely reinvested. These earnings relate to ongoing operations and have been reinvested in active business operations. While, following the enactment of the Tax Act, distributions from majority owned foreign affiliates are, generally, not subject to U.S. income tax, such distributions may be subject to non-U.S. withholding taxes. A deferred tax liability related to such withholding taxes, and U.S. taxes related to non-majority owned foreign investments have not been recorded.

The Tax Act implemented a new tax on foreign subsidiary income. The Company books Global Intangible Low-Taxed Income ("GILTI") on a current basis and does not book deferred taxes related to GILTI.

The Company accounts for uncertain tax positions based on a two-step process of evaluating recognition and measurement criteria. The first step assesses whether the tax position is more likely than not to be sustained upon examination by the taxing authority, including resolution of any appeals or litigation, on the basis of the technical merits of the position. If the tax position meets the more-likely-than-not criteria, the portion of the tax benefit greater than 50% likely to be realized upon settlement with the relevant tax authority is recognized in the financial statements. No significant changes in uncertain tax positions are expected in the next twelve months.

A reconciliation of the beginning and ending amount of gross unrecognized tax benefits is as follows (in thousands):

	Year Ended December 31,		
	2019	2018	2017
Balance, beginning of year	\$ 89	\$ 327	\$ 120
Increases (decreases) to tax positions related to prior periods	19	(243)	91
Increases to tax positions related to the current year	5	5	116
Balance, end of year	<u>\$ 113</u>	<u>\$ 89</u>	<u>\$ 327</u>

17. Employee Benefits

The Company has a 401(k) plan for its U.S. employees. The plan allows employees to contribute a percentage of their pretax earnings annually, subject to limitations imposed by the Internal Revenue Service. The plan also allows the Company to make a matching contribution, subject to certain limitations. To date, the Company has made no contributions to the 401(k) plan.

18. Quarterly Financial Information (Unaudited)

The following table contains quarterly financial data for the years ended December 31, 2019 and 2018 (in thousands, except per share data). The unaudited quarterly information has been prepared on a basis consistent with the audited consolidated financial statements and includes all adjustments that the Company considers necessary for a fair presentation of the information shown. The operating results for any fiscal quarter are not necessarily indicative of the operating results for a full fiscal year or any future period and there can be no assurances that any trend reflected in such results will continue in the future.

	Three Months Ended							
	Dec. 31, 2019	Sept. 30, 2019	Jun. 30, 2019	Mar. 31, 2019	Dec. 31, 2018	Sept. 30, 2018	Jun. 30, 2018	Mar. 31, 2018
Total revenues	\$ 105,483	\$ 99,276	\$ 92,199	\$ 86,978	\$ 82,640	\$ 78,164	\$ 73,392	\$ 69,760
Gross profit	17,734	17,445	14,713	15,032	14,205	13,744	12,353	11,064
Net income (loss)	\$ 636	\$ 782	\$ (1,931)	\$ (1,296)	\$ (275)	\$ 1,205	\$ (377)	\$ (1,480)
Net income (loss) per share:								
Basic	\$ 0.02	\$ 0.02	\$ (0.06)	\$ (0.04)	\$ (0.01)	\$ 0.04	\$ (0.01)	\$ (0.05)
Diluted	\$ 0.02	\$ 0.02	\$ (0.06)	\$ (0.04)	\$ (0.01)	\$ 0.03	\$ (0.01)	\$ (0.05)
Weighted-average common shares outstanding:								
Basic	34,876,438	34,876,782	34,610,709	34,292,367	33,716,975	33,129,416	30,721,037	30,246,585
Diluted	36,354,620	36,399,136	34,610,709	34,292,367	33,716,975	36,385,360	30,721,037	30,246,585

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures***Evaluation of Disclosure Controls and Procedures***

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a- 15(e) and 15d- 15(e) under the Exchange Act), as of the end of the period covered by this Annual Report on Form 10-K. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of such date, our disclosure controls and procedures were effective.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined under Rule 13a-15(f) and 15d-15(f) under the Exchange Act. Management has assessed the effectiveness of its internal control over financial reporting as of December 31, 2019 based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework). As a result of this assessment, management concluded that, as of December 31, 2019, its internal control over financial reporting was effective in providing reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Ernst & Young has independently assessed the effectiveness of the Company's internal control over financial reporting and its report is included below.

Changes in Internal Control

There were no changes in our internal control over financial reporting identified in management's evaluation pursuant to Rules 13a-15(d) or 15d-15(d) of the Exchange Act during the quarter ended December 31, 2019 that materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures

In designing and evaluating the disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of Trupanion, Inc.

Opinion on Internal Control over Financial Reporting

We have audited Trupanion, Inc.'s internal control over financial reporting as of December 31, 2019, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (2013 framework) (the COSO criteria). In our opinion, Trupanion, Inc. (the Company) maintained, in all material respects, effective internal control over financial reporting as of December 31, 2019, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), the consolidated balance sheets of the Company as of December 31, 2019 and 2018, the related consolidated statements of operations, comprehensive loss, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2019, and the related notes and the financial statement schedule listed in the Index at Item 15(a) and our report dated February 13, 2020 expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Ernst & Young LLP

Seattle, Washington

February 13, 2020

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

Information required by this item is incorporated herein by reference to our Proxy Statement with respect to our 2020 Annual Meeting of Stockholders to be filed with the SEC within 120 days of the end of the fiscal year covered by this Annual Report.

Item 11. Executive Compensation

Information required by this item is incorporated herein by reference to our Proxy Statement with respect to our 2020 Annual Meeting of Stockholders to be filed with the SEC within 120 days of the end of the fiscal year covered by this Annual Report.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Information required by this item is incorporated herein by reference to our Proxy Statement with respect to our 2020 Annual Meeting of Stockholders to be filed with the SEC within 120 days of the end of the fiscal year covered by this Annual Report.

Item 13. Certain Relationships and Related Transactions and Director Independence

Information required by this item is incorporated herein by reference to our Proxy Statement with respect to our 2020 Annual Meeting of Stockholders to be filed with the SEC within 120 days of the end of the fiscal year covered by this Annual Report.

Item 14. Principal Accountant Fees and Services

Information required by this item is incorporated herein by reference to our Proxy Statement with respect to our 2020 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report.

PART IV

Item 15. Exhibits, Financial Statement Schedules

(a)(1) Financial Statements

We have filed the financial statements listed in the Index to Financial Statements as a part of this Annual Report on Form 10-K.

(a)(2) Financial Statement Schedules

Schedule I Condensed Financial Information of Registrant

No other financial statement schedules have been provided because the information called for is not required or is shown either in the financial statements or notes thereto.

(a)(3) Exhibits

The following exhibits are filed as part of this Annual Report on Form 10-K or are incorporated herein by reference.

Exhibit Number	Exhibit Description	Form	Incorporated by Reference			Filed/ Furnished Herewith
			File No.	Exhibit	Exhibit Filing Date	
<u>3.1</u>	<u>Restated Certificate of Incorporation of the Registrant.</u>	10-Q	001-36537	3.1	8/28/2014	
<u>3.2</u>	<u>Certificate of Amendment to the Restated Certificate of Incorporation of the Registrant.</u>	8-K	001-36537	3.1	6/3/2016	
<u>3.3</u>	<u>Amended and Restated Bylaws of the Registrant.</u>	10-Q	001-36537	3.2	8/28/2014	
<u>4.1</u>	<u>Description of Capital Stock</u>					X
<u>4.2</u>	<u>Form of Common Stock Certificate.</u>	S-1	333-196814	4.1	6/16/2014	
<u>10.1+</u>	<u>Form of Indemnity Agreement.</u>	S-1	333-196814	10.1	6/16/2014	
<u>10.2+</u>	<u>2007 Equity Compensation Plan and forms of stock option agreements and exercise notices, restricted stock notice agreement and restricted stock agreement thereunder.</u>	S-1	333-196814	10.2	6/16/2014	
<u>10.3+</u>	<u>2014 Equity Incentive Plan and forms of stock option award agreement, restricted stock agreement and restricted stock unit award agreement thereunder.</u>	S-1	333-196814	10.3	6/16/2014	
<u>10.4+</u>	<u>2014 Employee Stock Purchase Plan.</u>	S-1	333-196814	10.4	6/16/2014	
<u>10.5+</u>	<u>Amended and Restated Employment Agreement, dated April 20, 2007, by and between the Registrant and Darryl Rawlings.</u>	S-1	333-196814	10.6	6/16/2014	
<u>10.6+</u>	<u>Consulting Agreement, dated May 5, 2014, by and between the Registrant and Howard Rubin.</u>	S-1	333-196814	10.8	6/16/2014	
<u>10.7+</u>	<u>First Amendment to Consulting Agreement, dated January 1, 2016, by and between the Registrant and Howard Rubin.</u>	10-Q	001-36537	10.2	5/6/2016	
<u>10.8+</u>	<u>Second Amendment to Consulting Agreement, dated January 1, 2017 by and between the Registrant and Howard Rubin.</u>	10-K	001-36537	10.13	2/15/2017	
<u>10.9+</u>	<u>Third Amendment to Consulting Agreement, dated January 1, 2019 by and between the Registrant and Howard Rubin.</u>	10-Q	001-36537	10.2	5/3/2019	
<u>10.10</u>	<u>Senior Credit Facility Loan and Security Agreement, entered into as of December 16, 2016 between Pacific Western Bank, Western Alliance Bank and the Registrant.</u>	10-K	001-36537	10.15	2/15/2017	
<u>10.11</u>	<u>First Amendment to Senior Credit Facility Loan and Security Agreement, dated March 31, 2017 between Pacific Western Bank, Western Alliance Bank and the Registrant.</u>	10-Q	001-36537	10.1	5/3/2017	

<u>10.12</u>	<u>Second Amendment to Senior Credit Facility Loan and Security Agreement, dated September 28, 2017 between Pacific Western Bank, Western Alliance Bank and the Registrant.</u>	10-Q	001-36537	10.1	11/3/2017	
<u>10.13</u>	<u>Third Amendment to Senior Credit Facility Loan and Security Agreement, dated June 28, 2018, between Pacific Western Bank, Western Alliance Bank and the Registrant.</u>	10-Q	001-36537	10.1	8/3/2018	
<u>10.14</u>	<u>Joinder to Loan and Security Agreement and Amendment and Restated Revolving Note, dated August 6, 2018, between Pacific Western Bank, Western Alliance Bank, Trupanion Managers USA, Inc. and Trupanion-APIC, LLC.</u>	10-Q	001-36537	10.2	11/9/2018	
<u>10.15</u>	<u>Fourth Amendment to Senior Credit Facility Loan and Security Agreement, dated April 29, 2019, between Pacific Western Bank, Western Alliance Bank and the Registrant.</u>	10-Q	001-36537	10.1	7/31/2019	
<u>10.16</u>	<u>Real Estate Purchase and Sale Agreement, dated June 18, 2018, between the Registrant and Benaroya Capital Company, L.L.C.</u>	8-K	001-36537	10.1	6/20/2018	
<u>10.17†</u>	<u>Agency Agreement between Omega General Insurance Company and Trupanion Brokers Ontario, Inc., effective January 1, 2015.</u>	10-K	001-36537	10.13	2/24/2015	
<u>10.18†</u>	<u>Fronting and Administration Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective January 1, 2015.</u>	10-K	001-36537	10.14	2/24/2015	
<u>10.19†</u>	<u>Quota Share Reinsurance Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective January 1, 2015.</u>	10-K	001-36537	10.15	2/24/2015	
<u>10.20</u>	<u>Quota Share Reinsurance Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective January 1, 2018.</u>	10-K	001-36537	10.20	2/14/2018	
<u>10.21</u>	<u>Quota Share Reinsurance Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective January 1, 2019.</u>	10-K	001-36537	10.19	2/14/2019	
<u>10.22</u>	<u>Quota Share Reinsurance Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective January 1, 2020.</u>					X
<u>10.23</u>	<u>Quota Share Reinsurance Agreement between Wyndham Insurance Company (SAC) Limited and Omega General Insurance Company, effective July 1, 2020.</u>					X
<u>10.24+</u>	<u>Compensation Program for Non-Employee Directors of Trupanion, Inc. as amended on December 27, 2018.</u>	10-K	001-36537	10.20	2/14/2019	
<u>10.25+</u>	<u>Compensation Clawback Policy, effective February 11, 2019.</u>	10-K	001-36537	10.21	2/14/2019	
<u>10.26+</u>	<u>On-Going Severance Policy for CEO and Key Senior Leaders, effective February 11, 2019.</u>	10-K	001-36537	10.22	2/14/2019	
<u>10.27+</u>	<u>Change of Control Policy for Select Officers and Key Leaders effective February 11, 2019.</u>	10-K	001-36537	10.23	2/14/2019	
<u>21.1</u>	<u>Subsidiaries of the Registrant.</u>					X
<u>23.1</u>	<u>Consent of independent registered public accounting firm.</u>					X

<u>24.1</u>	<u>Power of Attorney (reference is made to the signature page hereto).</u>	X
<u>31.1</u>	<u>Certification of Principal Executive Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	X
<u>31.2</u>	<u>Certification of Principal Financial Officer, pursuant to Rule 13a-14(a)/15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.</u>	X
<u>32.1*</u>	<u>Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>	X
<u>32.2*</u>	<u>Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u>	X
101.INS	XBRL Instance Document - the instance does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.	X
101.SCH	Inline XBRL Taxonomy Extension Schema Document.	X
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document.	X
101.DEF	Inline XBRL Taxonomy Extension Definition Linkbase Document.	X
101.LAB	Inline XBRL Taxonomy Extension Labels Linkbase Document.	X
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document.	X
104	Cover Page Interactive Data File (formatted in Inline XBRL and contained in Exhibit 101)	X

+ Indicates a management contract or compensatory plan or arrangement.

† Registrant has omitted portions of the referenced exhibit pursuant to a request for confidential treatment under Rule 24b-2 promulgated under the Exchange Act. The omitted portions of this exhibit have been filed separately with the SEC.

* This certification is deemed not filed for purpose of section 18 of the Exchange Act or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference into any filing under the Securities Act or the Exchange Act.

Item 16. Form 10-K Summary

None.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, in the city of Seattle, state of Washington, on this 13th day of February, 2020.

TRUPANION, INC.

By: /s/ Darryl Rawlings

Darryl Rawlings
Chief Executive Officer and President

POWER OF ATTORNEY

KNOW ALL PERSONS BY THESE PRESENTS, that each person whose signature appears below hereby constitutes and appoints Darryl Rawlings, Tricia Plouf and Asher Bearman, and each of them, as his or her true and lawful attorneys-in-fact, proxies and agents, each with full power of substitution, for him or her in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with all exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact, proxies and agents full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully for all intents and purposes as he or she might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact, proxies and agents, or their or his or her substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: February 13, 2020

/s/ Darryl Rawlings

Darryl Rawlings
Chief Executive Officer and President
(Principal Executive Officer)

Date: February 13, 2020

/s/ Tricia Plouf

Tricia Plouf
Chief Financial Officer
(Principal Financial and Accounting Officer)

Date: February 13, 2020

/s/ Murray Low

Murray Low
Chairman of the Board of Directors

Date: February 13, 2020

/s/ Jacqueline Davidson

Jacqueline Davidson
Director

Date: February 13, 2020

/s/ Michael Doak

Michael Doak
Director

Date: February 13, 2020

/s/ Robin Ferracone

Robin Ferracone
Director

Date: February 13, 2020

/s/ Dan Levitan

Dan Levitan
Director

Date: February 13, 2020

/s/ H. Hays Lindsley

H. Hays Lindsley
Director

Date: February 13, 2020

/s/ Howard Rubin

Howard Rubin
Director

Schedule I - Condensed Financial Information of Registrant

Trupanion, Inc.
Condensed Statements of Operations and Comprehensive Loss
(Parent Company Only, in thousands)

	Year Ended December 31,		
	2019	2018	2017
Expenses:			
Veterinary invoice expense	\$ 697	\$ 571	\$ 354
Other cost of revenue	353	357	239
Technology and development	1,085	512	528
General and administrative	5,974	4,879	4,204
Sales and marketing	2,137	1,355	889
Total expenses	10,246	7,674	6,214
Gain (loss) from investment in joint venture	(205)	—	—
Operating loss	(10,451)	(7,674)	(6,214)
Interest expense	1,327	1,184	529
Other (income) expense, net	(4,156)	(2,557)	(4,101)
Loss before equity in undistributed earnings of subsidiaries	(7,622)	(6,301)	(2,642)
Income tax benefit	5,423	4,042	5,302
Equity (loss) in undistributed earnings of subsidiaries	390	1,332	(4,163)
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)
Other comprehensive income (loss), net of taxes:			
Other comprehensive income (loss) of subsidiaries	1,003	(661)	285
Other comprehensive income (loss)	1,003	(661)	285
Comprehensive loss	\$ (806)	\$ (1,588)	\$ (1,218)

Trupanion, Inc.
Condensed Balance Sheets
(Parent Company Only)
(In thousands, except share data)

	December 31,	
	2019	2018
Assets		
Current assets:		
Cash and cash equivalents	\$ 1,242	\$ 2,133
Accounts and other receivables	2,933	2,094
Prepaid expenses and other assets	361	661
Total current assets	4,536	4,888
Restricted cash	1,400	1,400
Property and equipment, net	663	568
Intangible assets, net	5,356	5,076
Other long-term assets	14,146	6,515
Advances to and investments in subsidiaries	138,174	125,475
Total assets	<u>\$ 164,275</u>	<u>\$ 143,922</u>
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable, accrued liabilities, and other current liabilities	\$ 311	\$ 885
Total current liabilities	311	885
Long-term debt	26,086	12,862
Deferred tax liabilities	1,118	1,002
Total liabilities	27,515	14,749
Stockholders' equity:		
Common stock: \$0.00001 par value per share, 100,000,000 shares authorized at December 31, 2019 and December 31, 2018, 35,876,882 and 34,947,017 shares issued and outstanding at December 31, 2019; 34,781,121 and 34,025,136 shares issued and outstanding at December 31, 2018	—	—
Preferred stock: \$0.00001 par value per share, 10,000,000 shares authorized at December 31, 2019 and December 31, 2018, and 0 shares issued and outstanding at December 31, 2019 and December 31, 2018	—	—
Additional paid-in capital	232,731	219,838
Accumulated other comprehensive income (loss)	250	(753)
Accumulated deficit	(85,520)	(83,711)
Treasury stock, at cost: 929,865 shares at December 31, 2019 and 755,985 shares at December 31, 2018	(10,701)	(6,201)
Total stockholders' equity	136,760	129,173
Total liabilities and stockholders' equity	<u>\$ 164,275</u>	<u>\$ 143,922</u>

Trupanion, Inc.
Condensed Statements of Cash Flows
(Parent Company Only, in thousands)

	Year Ended December 31,		
	2019	2018	2017
Operating activities			
Net loss	\$ (1,809)	\$ (927)	\$ (1,503)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:			
(Income) loss attributable to investments in subsidiaries	(390)	(1,332)	4,163
Depreciation and amortization	211	436	697
Stock-based compensation expense	6,846	4,775	3,419
Gain on sale of equity method investment	—	—	(1,036)
Other, net	48	108	(380)
Changes in operating assets and liabilities	(601)	(97)	743
Net cash provided by (used in) operating activities	4,305	2,963	6,103
Investing activities			
Proceeds from sale of equity method investment	—	—	1,402
Purchases of property and equipment	(728)	(164)	(135)
Advances to and investments in subsidiaries	(11,931)	(67,884)	(12,168)
Other investments	(7,019)	(4,237)	(2,668)
Net cash used in investing activities	(19,678)	(72,285)	(13,570)
Financing activities			
Proceeds from public offering of common stock, net of offering costs	—	65,671	—
Proceeds from exercise of stock options	2,982	3,601	2,545
Taxes paid related to net share settlement of equity awards	(1,667)	(1,839)	(1,170)
Proceeds from debt financing, net of financing fees	13,167	13,430	4,400
Repayments of debt financing	—	(10,000)	—
Other financing	—	287	(604)
Net cash provided by financing activities	14,482	71,150	5,170
Net change in cash, cash equivalents, and restricted cash	(891)	1,828	(2,297)
Cash, cash equivalents, and restricted cash at beginning of period	3,533	1,705	4,001
Cash, cash equivalents, and restricted cash at end of period	<u>\$ 2,642</u>	<u>\$ 3,533</u>	<u>\$ 1,705</u>
Supplemental disclosures			
Interest paid	\$ 1,166	\$ 1,007	\$ 333
Noncash investing and financing activities:			
Property and equipment acquired under capital lease	—	—	471
Cashless exercise of common stock warrants	4,500	3,000	—
Issuance of common stock for acquisition of corporate real estate	\$ —	\$ 9,640	\$ —

1. Organization and Presentation

The accompanying condensed financial statements present the financial position, results of operations and cash flows for Trupanion, Inc. These condensed unconsolidated financial statements should be read in conjunction with the consolidated financial statements of Trupanion, Inc. and its subsidiaries and the notes thereto (the Consolidated Financial Statements). Investments in subsidiaries are accounted for using the equity method of accounting. Trupanion, Inc. received cash dividends from a subsidiary of \$3.9 million, \$2.2 million and \$2.7 million for the years ended December 31, 2019, 2018 and 2017, respectively. These cash dividends were recorded within Trupanion, Inc.'s other income and were eliminated within the consolidated financial statements of Trupanion, Inc.

Additional information about Trupanion, Inc.'s accounting policies pertaining to intangible assets, commitments and contingencies, debt financing, stock-based compensation, stockholders' equity, and income taxes are set forth in Notes 4, 8, 10, 11, 13, and 16, respectively, to the Consolidated Financial Statements.

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