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Trupanion, Inc.

First Quarter 2022 Earnings Call

April 28, 2022

CORPORATE PARTICIPANTS

Laura Bainbridge, *Investor Relations*

Darryl Rawlings, *Chief Executive Officer*

Drew Wolff, *Chief Financial Officer*

Margi Tooth, *President*

Tricia Plouf, *Chief Operating Officer*

CONFERENCE CALL PARTICIPANTS

Shweta Khajuria, *Evercore ISI*

Maria Ripps, *Canaccord Genuity, Inc.*

Elliot Wilbur, *Raymond James*

Joshua Shanker, *Bank of America*

Jon Block, *Stifel*

John Barnidge, *Piper Sandler*

Greg Gibas, *Northland Securities*

Ryan Tunis, *Autonomous Research*

PRESENTATION

Operator

Greetings, and welcome to the Trupanion Inc. First Quarter 2022 Earnings Call.

As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Laura Bainbridge, Investor Relations, Trupanion. Please go ahead.

Laura Bainbridge

Good afternoon, and welcome to Trupanion's first quarter 2022 financial results conference call. Participating on today's call are Darryl Rawlings, Chief Executive Officer, and Drew Wolff, Chief Financial Officer. Similar to prior earning calls, Margi Tooth, President, and Tricia Plouf, Chief Operating Officer, will be available for the Q&A portion of today's call.

Before we begin, I would like to remind everyone that during today's conference call we will make certain forward-looking statements regarding the future operations, opportunities and financial performances of Trupanion within the meaning of the Safe Harbor provision of the Private Securities Litigation Reform Act of 1995.

These statements involve a high degree of known and unknown risks and uncertainties that could cause actual results to differ materially from those discussed. A detailed discussion of these and other risks and uncertainties are included in our earnings release, which can be found on our Investor Relations website, as well as the Company's most recent report on Forms 10-K and 8-K filed with the Securities and Exchange Commission.

Today's presentation contains references to non-GAAP financial measures that management uses to evaluate the Company's performance including, without limitation, fixed expenses, variable expenses, adjusted operating income, acquisition costs, internal rate of return, Adjusted EBITDA and free cash flow. When we use the term adjusted operating income or margin, it is intended to refer to our non-GAAP operating income or margin before new pet acquisition.

Unless otherwise noted, margins and expenses will be presented on a non-GAAP basis, which excludes stock-based compensation expense and depreciation expense. These non-GAAP measures are in addition to, and not a substitute for, measures of financial performance prepared in accordance with the U.S. GAAP. Investors are encouraged to review the reconciliations of these non-GAAP financial measures to the most directly comparable GAAP results, which can be found in today's press release or on Trupanion's Investor Relations website under the Quarterly Earnings tab.

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

With that, I will hand the call over to Darryl.

Darryl Rawlings

Thanks, Laura, and good afternoon, everyone.

Earlier this week, we published my annual shareholder letter. Outside of our annual meeting, my letters are intended to be the best source of information to educate yourself on Trupanion. It explains the way we think about and run our business. I'll touch on a few of the highlights today, but I would encourage you to read it in its entirety.

Turning to Q1, the year is off to a strong start, as shown in our financial results. Adjusted operating income, or the funds generated from our existing portfolio of pets, increased 29% to approximately $22 million.

You've heard me say this before but it's worth repeating. The vast majority of Trupanion's intrinsic value is derived from our core subscription business. In the quarter, approximately 90% or $20 million of our adjusted operating income was generated from our subscription business. This represents growth of 26% year-over-year.

As a percent of our subscription revenue, adjusted operating income expanded 40 basis points year-over-year to 14%. In our large underpenetrated market, pet acquisition remains the primary use of our adjusted operating income.

In the quarter, we were able to deploy approximately 14% more funds year-over-year or $19 million within our subscription business at a 34% estimated internal rate of return. In the quarter, we added nearly 60,000 new subscription pets in line with our expectations, an another all time high.

Members with our Trupanion branded products are staying with us longer than ever before, on average 80 months. This highlights our exceptional member experience and continues to be especially impressive in light of our accelerated growth. Improvement in our trailing 12-month retention, coupled with expansion in our subscription adjusted operating margin, drove a 7% increase in lifetime value of a pet, which topped $730 in the quarter. In short, performance was strong and we are optimistic about the road ahead.

With many of the COVID disruptions of the past two years hopefully behind us, we are excited to get back in front of veterinarians and their staff.

In my shareholder letter, I shared key metrics around the veterinary channel. Active hospitals totaled 14,700 at the end of 2021. Since then, that number has continued to grow to over 15,600 at the end of the first quarter. Though face to face visits have been lower over the past two years, growth in active hospitals continues to benefit from the strength of our brand.

As the penetration rate of Trupanion members continues to increase within individual veterinary clinic, in some markets, we are beginning to witness a flywheel effect where our value proposition and customer experience increases the confidence and trust of our product to both new pet owners, veterinarians and their staff.

With veterinarian doors opening again and territory partners back in the field, we are excited to continue to build on the momentum of this key metric. On a trailing 12-month basis, our TruTopia gap was 30 basis points. TruTopia provides the pathway to self-sustaining growth with minimal acquisition spend. For additional details on TruTopia, please refer to our shareholder letters.

Achieving a state of TruTopia is a key component of our 60-month plan, as is new products, international markets and distribution channels, including through our partnerships with Aflac and Chewy.

While it's early days, we are excited to see how both of these key strategic partnerships will play out. Long-term initiatives, such as these, increase the odds of us growing at sustainably higher rates for longer periods of time.

For companies that are constantly reinvesting in growth, tracking value creation can be difficult. At Trupanion, we want to maximize value creation while at the same time making it easy for all of our constituents to track our progress in a very transparent way. In my recent shareholder letter, I provide more thoughts around value creation, including laying out the ways we intend to fund our growth.

At our annual shareholder meeting, we provide a high degree of transparency into our business through an extensive Q&A with the team members directly responsible for the execution of our 60-month plan. This year, our annual shareholder meeting will be held on June 8 at our Seattle headquarters. This event is optimized for an in-person attendance, and I would highly encourage those that are looking to better understand our business, our strategy and our culture to attend.

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

Drew Wolff

Thanks, Darryl, and good afternoon, everyone.

Total revenue for the quarter was $206 million, up 33% over year-over-year, driven by strong pet editions and continued high levels of retention in our subscription business along with continued growth within our other business. Within our subscription business segment, revenue was $139.8 million, up 23% over last year.

Total enrolled subscription pets increased 21% year-over-year to over 736,500 pets. Average monthly retention, which is calculated on a trailing 12-month basis, was 98.75% compared to 98.73% in the prior year period.

Given our accelerated growth, we're especially pleased to see first year retention continue to improve on a year-over-year basis.

Continued expansion of our average monthly retention rate means we're able to invest more in our growth and target the highest sustainable lifetime value in the industry.

As the size of our pet portfolio grows, so too does the value created from our high retention rates. Monthly average revenue per pet was $64.21, an increase of 2% year-over-year and growing ahead of our cost of veterinary invoices, which increased 0.8% over the same time period. This is probably not intuitive given the headlines around inflation.

Let me explain why. As a reminder, ARPU is an output of pricing accurately to our value proposition. And in the quarter, we delivered on our value proposition of 71%. While we hit our target in aggregate, we continue to refine our approach across over 1 million subcategories, including increasing or decreasing prices as necessary.

Over the past year, we've worked hard to optimize pricing, leading to more growth in some areas where our loss ratio was previously too low and less growth in some areas where it was too high. This is positively impacting the overall mix of our business.

For example, we are seeing higher rates of growth within the category of younger pets. Year-over-year growth in ARPU reflects this dynamic, as well as our broadened geographic distribution.

As a percentage of subscription revenue, variable expenses were 10%, reflecting investments in our member experience. We believe the benefit of this investment, as well as pricing accurately to our value proposition, is reflected in our increased retention.

Fixed expenses were consistent with last year at 4.9% of revenue. After the cost of veterinary invoices, variable expenses and fixed expenses, we calculated our adjusted operating income. Our subscription adjusted operating margin was 14% for the quarter, up from 13.6% in the prior year period and within 100 basis points of our target margin.

We expect to continue to see scale in our variable and fixed expenses over the next 12 months, resulting in our adjusted operating margin being closer to our 15% target on an annual basis. In dollars, our subscription business delivered adjusted operating income of $19.5 million, an increase of 26% over the prior year period. In the quarter, our subscription business accounted for 90% of our total adjusted operating income.

Now, I'll turn briefly to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and different margin profiles than our subscription business.

Total revenue was $66.2 million. Compared to the prior year quarter, this is an increase of 60% year-over-year, reflecting an increase in pets enrolled within this segment. Adjusted operating income for the segment was approximately $2.1 million. While lower margin, our other business provides scale and data and fixed expenses, and we incur virtually no acquisition spend within the segment. As a result, our total adjusted operating income was up 29% over the prior year period to $21.6 million.

During the quarter, we were able to invest 14% more year-over-year or $19.2 million to acquire nearly 60,000 new subscription pets. This resulted in a pet acquisition cost of $301 and estimated 34% internal rate of return for a single average pet.

As a reminder, our pet acquisition cost is fully loaded. Meaning it includes marketing, sales, call center and IT personnel that work on pet acquisition, as well as marginal advertising and promotion spend. We provide the details of how we calculate our IRR in the financial supplemental tables that can be found on our IR Web site.

I'll reinforce that, unlike some other consumer financial products where customer acquisition costs are amortized over the life of that customer, based on the niche of our monthly recurring policy, we recognize our acquisition spend upfront. We recoup these costs over the duration of a pet's life with Trupanion.

We also invested $1.3 million in the quarter on development costs. These are primarily related to new products, channels and international expansion, which we expect to deepen our competitive moats.

We continue to expect development expense of approximately 0.5% of revenue for the year. This resulted in an Adjusted EBITDA of $1.2 million compared to an Adjusted EBITDA loss of $1.1 million in the prior year quarter.

While we have ample growth opportunities ahead, we are often asked to about steady state, and what this business looks like if we were keeping pet count flat. I'll provide an illustrative example. But first, it's important to highlight our TruTopia dynamic or the growing portion of Trupanion's book that comes from cost effective referrals, pet owners adding pets or friend referrals. Of the 1.25% of pets we lose a month, approximately 95 basis points or 76% of that is being replaced by these lead sources. We refer to this frequently as our gap to TruTopia.

As our book grows, our brand and its reputation also grows, and with it, the number of pets rolling through word of mouth. When we are in TruTopia, these sources of pet enrollments entirely offset those that churn, delivering steady state or neutral pet count.

In the first quarter, if we were to enroll just enough pets to offset churn, excluding our other business segment, we would estimate standstill EBITDA would've been around 10% of subscription revenue. This also assumes our current variable and fixed expense ratios and reflects the powerful referral dynamic in our portfolio.

However, today with our large and underpenetrated market of just 2%, we are making a strategic decision to invest for growth and increase the embedded cash flow generation of our business, deploying greater sums of capital at a rate of return well in excess of our cost of capital over long periods of time is what drives value creation in this business.

We provide additional thoughts around value creation, including the effect of growing adjusted operating income and deploying compounding amounts at high internal rates of return, in Darryl's most recent annual shareholder letter. Total stock-based compensation expense was $7.4 million, inline with our expectations. This expense includes the initial amortization of our 2021 annual performance grants in February, which relate to the year-over-year growth in our estimated intrinsic value for 2021.

We estimate that we increased intrinsic value by 41%. And after adjusting for cash usage, we shared approximately 1.5% of this increase with the team. We believe this level of dilution is appropriate given the value creation. I'll reiterate that the majority of our share-based compensation is performance driven. If the Company doesn't grow intrinsic value by over 10%, there would not be any expected annual performance grants.

We expect stock-based compensation to be around $9 million per quarter for the remainder of this year. As a result, net loss was $8.9 million or a loss of $0.22 per basic and diluted share compared to a net loss of $12.4 million or a loss of $0.31 per basic and diluted share in the prior year period.

Turning to our balance sheet, we ended the quarter with over $259 million in cash, cash equivalents and short-term investments. Prior to quarter end, we entered into a five-year $150 million debt facility with an initial draw of $60 million. Further through my previous comments on capital allocation, the facility provides us a lower cost alternative to fund our growth, including offsetting amounts held for regulatory capital requirements.

With initiatives like Aflac and Chewy coming to market, we're thrilled to have additional flexibility and allow for the allocation of our discretionary income to areas where we can earn our targeted 30% to 40% estimated rates of return. We approximate the cost to services debt at less than 1% of revenue.

In terms of cash flow, operating cash flow was negative $3.6 million in the quarter compared to negative $1.7 million in the prior year period. Capital expenditures totaled $3.6 million in the quarter. And as a result, free cash flow was a negative $7.1 million.

Following the first quarter of 2022, I'll reiterate that we continue to target growing subscription adjusted operating income by 25% for the year. We plan to continue deploying as much capital as we are able to within our IRR guardrails of 30% to 40%.

We continue to be on track to ramp up several of the initiatives in our 60-month plan that, if successful, would begin to manifest in our results in the second half of '22, but more meaningfully so in 2023. We look forward to keeping you apprised of our progress.

With that, I'll hand it back over to Darryl.

Darryl Rawlings

Thanks, Drew.

Before we open it up for questions, I want to remind you of a few upcoming Investor Relations events. This weekend, Margi, Tricia, Drew and myself, will be hosting our annual Q&A in Omaha. This is a great venue to connect with like-minded investors. We hope to see you there.

As I mentioned earlier, but worth repeating, our annual shareholder meeting will be held on June 8. We are excited to once again host shareholders and guests at our headquarters in Seattle. I encourage you to visit in person if you are so able and to register as soon as possible on our Investor Relations website.

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

Operator

Thank you very much. We have our first question from the line Shweta Khajuria with Evercore ISI. Please go ahead.

Shweta Khajuria

Let me start with two, please. So on Page 15 of your shareholder letter, you have this table with the active hospitals and Darryl talked about it a little bit in you're prepared remarks. So I guess the question really is where do you think—so right now it seems like your active hospital penetration is about 52%. There are 28,000 in three countries. You're at 14.7k. Where do you think that can go? And then the same question for 1.26 in terms of new pets per active hospital. How should we think about where that can go? So that's the first question. And then the second question is how do you think you did in the quarter in your subscription revenue or subscription pets versus your internal expectations for the quarter? Thank you.

Darryl Rawlings

Well, the active hospitals is a really important question. I mean, if you go back to how we build out our DCF (phon) model to value us from an intrinsic value standpoint, the biggest drivers we have is a number of active hospitals, and then the second is same-store sales. We ended the year at about 14,700, I believe, but I mentioned in my opening remarks we were about 15,600.

When I look at certain markets, markets that we've been in longer, I can see that we could get to the point where 80% to 90% of hospitals in an area are actively recommending us, and that's what we're will be focused for in the years to come.

As far as same-store sales, I don't think we've seen the upper limit on that number yet. We certainly have many of our A rated hospitals that have same-store sales of over 10 pets per month. But how man—what percentage of actual hospitals we can get it to that level, I think is a little early. I would expect that year-over-year that we see improvements but I'm not really here to speculate on the growth of that over the next five or 10 years.

And as far as revenue expectations, I think I'll hand that over to Margi.

Margi Tooth

Yes. In terms of overall pets and how do we do in Q1, I think we talked a lot about momentum in the last call last quarter, and that momentum continued right the way through the end of the quarter and continues now into April.

Expectations of it bang on, I think we are performing well. The team is very aligned, we've seen some really strong communication and really the flywheel it's turning quite nicely. So all in all really in line with expectations and encouraged by what we're seeing for that momentum to continue.

Shweta Khajuria

Okay. Thanks, Darryl. Thanks, Margi.

Margi Tooth

Thank you.

Operator

Thank you. We have next question from the line of Maria Ripps with Canaccord Genuity. Please go ahead.

Maria Ripps

Great. Thanks so much for taking my questions and I appreciate all the color in the shareholder letter.

First on your annual scorecard this year, you rate your member experience as B, while your sort of monthly retention rate continues to improve year after year. I guess, what are some areas where you think you can still improve? And if your member experience is at an optimal level, where would you like to see your retention level versus 98.75% that you just reported?

Darryl Rawlings

Well, this year in my shareholder letter, Margi and Trish draw the scorecards. So I'll let them answer the question.

Margi Tooth

Thanks, Darryl. Hi, Maria.

Just as a reminder, when we were scoring this the way that Trish and I were looking at this through the lens of, we have a 60-month road map and let's look at the 12 months and where our expectations in the first 12 months to the 60-month plan. So our expectations of a B were it's performing pretty well, pretty happy with it.

You've seen the retention rates. We're very happy with the way that's been moving. In terms of areas of opportunity, we believe we can definitely increase the penetration rate of our software, make sure that we've got more hospitals utilizing that on a very more routine basis, more a regular basis.

We're seeing it moving in a positive direction. And we know when we see that being used more frequently, then the overall retention rate improves. Our member experience is better. We have less need for people to contact us because their claim is being settled. They know what's happening and the vets are happy too.

I think, all-in-all that's probably the biggest opportunity we have there. The teams are doing a really good job of making sure that there is clarity with their coverage, which leads to better—more positive member experience and higher referral of friends.

In terms of working retention get to our goal on the 60-month plan is 99%. We think that that's as good as virtually perfect. I will tell you now there are areas we have above 99%. So that's beyond an A-plus and we are happy with that. But I think all-in-all we're shooting for 99%. Unfortunately, we can't say the pet will ultimately end up passing away, but we believe that that 1% is—know that we can get to hopefully.

Trish, anything you would add?

Maria Ripps

Great. Thanks, Margi.

And maybe my second question is, can you maybe update us on your progress with Chewy and Aflac partnerships? And any color you can share on how close you are to launching with Chewy, and whether there are any states that were already launched?

Margi Tooth

Sure yes. So if I take Chewy first. So Chewy, really well aligned partner, both actually Chewy and Aflac very well aligned partners. For Chewy, we are commencing imminently our phased launched.

We are very excited and we remain excited about the potential with that partnership. Our core businesses continue to perform strongly well. Behind the scenes, we've had both teams with Chewy, Aflac and Trupanion, all of them working hard to basically get ready for these product launches. So really excited to see that coming to fruition very soon.

In terms of Aflac, so Phase 1 launch is in March. As a reminder, the work site cycle, sales cycle, takes a long time. So anything that we would expect to come from the launch wouldn't hit until 2023, realistically. And just talking about what a launch means, it really means that we are starting to work with the brokers, with the Aflac team, who have been partnering with us to introduce us to the brokers, to have the conversations and start that pipeline opening up, which has been encouraging to begin with.

Maria Ripps

Great. Thanks so much for the color.

Margi Tooth

You're welcome.

Operator

Thank you. We have next question from the line of Elliot Wilbur with Raymond James. Please go ahead.

Elliot Wilbur

Thanks. Good afternoon.

First question is just with respect to sort of the trends in overall vet clinic visit volumes as we've seen year-to-date. I guess, just given some of the services they are reporting a deceleration or actually decline in overall vet visits, wondering if that has impacted your deployment of discretionary capital at all between lead generation and conversion strategies.

Darryl Rawlings

Let me get Trish to answer the first part of it with kind of the data that we are seeing on the claim side and visit patterns, and then Margi can follow-up.

Tricia Plouf

Sure. I'm happy to kick it off. In general, we have seen some of those industry details as well and we are not seeing that same trend in our data. We are seeing overall increase in frequency. So kind of the

frequency of invoices that come in was up a little bit over the quarter, and we are active in an illness coverage. So we are happy that when we're here for our members, when they need to use the product, they are using it. We are here for them; we are paying the claims.

We are actually paying claims now faster than we ever have before, which is helping with that member experience. So our overall data trends within our membership base are not following that.

Another data point that I'll give that looks at longer periods of time, because things have kind of moved around the past two years with COVID impacts in particular at the vet hospital. When we look back to 2019 Q1, pre COVID, our average frequency, the number of the invoices that we get, as well as the average dollar amounts per invoice, are actually up compared to 2019.

We're seeing the trends, we're seeing the usage, and we're encouraged by that, and obviously continue to then price to our value proposition.

I'll let Margi speak to kind of the lead side of it.

Margi Tooth

Thanks, Trish.

In terms of the leads overall and the impact on discretionary spend. So one of the things we mentioned in the last quarter call was the fact that our territory partners can get back out in the field, and visiting hospitals, and they're rebuilding those relationships. And we saw that in Q1; we've seen a tremendous uplift in our lead channel that's coming from the vet channel specifically. So when we talk about vet traffic that certainly has a new effect on metrics and the vet channel for us is the hotline of everything that we do.

As we think about the benefit to the business that means that we have a more efficiently sourced and the conversion than is that is also more efficient, because we know that we can convert at the higher rate. And that ultimately then allows us to think about other areas that we'll be investing other discretionary capital. So it's all in all looking very healthy from that perspective, and really pleased to see the impact of having territory partners back in the field and having conversations with hospitals.

Elliot Wilbur

Thanks. And I guess your comments sort of read into my next question, but just thinking about—I think… What is it, Table 19 in Darryl's letter with the deals with the vet hospital metrics? So if you think about just sort of the number of high frequency hospitals or hospitals that you're visiting within every 60 days to 90 days. I mean, that metric is still down roughly 20% versus 2019, but the number of hospitals you're calling on has expanded. So that in aggregate the number of face-to-face visits has increased.

But how do we think about the recovery in call patterns in terms of hospitals that you're visiting every 60 days to 90 days in terms of impacting your overall book of business? Trying to get a sense of just how important it is sort of recapturing the higher frequency of visits here versus just expanding the overall number of hospitals that you're calling on.

Tricia Plouf

I mean, I think you said it very well yourself. In terms of the impact to the business, it's incredibly impactful. So when we're thinking about 2019, 2020, '21 and now where we are in 2022 with the first

quarter behind us, our visit pattern has got back up to 2019 levels, which is what we were aiming for. And it obviously got there a little quicker than I think any of us were expecting.

So people are really excited to have the territory partners back in hospitals. The territory partners are very excited to have them going back in. The impact overall to the business is throughout the performance of the business. It helps from a lead generation perspective. It helps with conversion, because the introduction is that much stronger, people understand the benefits of high-quality medical insurance.

And ultimately from a retention perspective, member experience referral rates, we see all of that coming together to improve the experience, both from a hospital, but also from a member point of view. And I think, for us it's critical that we were getting back in the field as quickly as we could without putting hospitals and territory partners at risk.

We now feel confident about that, and I think just seeing the momentum that we've had over the last three months and now carried on into April will tell you just how critical that is for us as a moat, and how deep that moat is because it's continuing to help us grow that lead volume.

I think in terms of the number of hospitals that we address, we're always looking at making sure that we can go what we internally would refer to going wide. So as many sources as we possibly can, but also going deep. We're looking at, as Darryl mentioned a moment ago, how do we get that standstill sales number up, how do we build a habit, how do we help people and to understand that that repeat conversation about insurance is really critical and it helps get greater frequency of care, greater numbers going into the hospitals and perhaps having the treatment that they need, which reinforces the value of Trupanion.

Does that answer your question?

Elliot Wilbur

Yes. Thanks. And then just last question, I believe for Drew. I just want to ask, maybe get a little bit more insight into what is driving the relative increase in terms of subscription variable expenses. I think that number's gone up as a percent of subscription revenue by about 100 basis points since year end 2020.

Just maybe want to get a little bit more granularity in terms of some of the incremental investments that are being made. Whether that's member experience, or if it's just kind of—this is just kind of natural evolution of sort of the higher retention costs kind of embedded in a larger book of business. Just trying to get a sense as to when that number may moderate, you know, what investments are being made that maybe by consider transitory or temporary. And just trying to get a sense of when that basically—when that expense ratio basically caps out. Thanks.

Drew Wolff

Yes. Our target 15% margin is an annual target and it does fluctuate quarter to quarter. Q1 tends to be a heavier quarter for us, just as seasonality of some of our expenses. But specifically, we invested in retention this quarter. And we'll get into specifics of what those initiatives were. But I would say that Q1 is always a harder quarter for retention and we put up our best Q1 retention number ever, specifically in first year retention. So we saw the value of making that investment and dialing it up.

There's interplay between fixed and variable. And between the two, we expect those to scale down and march down throughout the year as a percentage of revenue. So we expect to land the year between 14% and 15% margin. But we do expect to get scale, this is probably the high point.

Operator

Yes, thank you. Your next question from the line of Josh Shanker from Bank of America. Please go ahead.

Joshua Shanker

Yes. Thank you taking my call.

I guess, Drew for the first question. And I joined a few minutes late. You might have mentioned it. It looks like there were a lot of prepaid expenses: vet bill, accounts payable and prepaid expenses broadly in the quarter that hit cash flow in 1Q. Wondering what's going on, is there some seasonal information there, does that have a true-up later in the year.

Drew Wolff

Yes. Q1 tends to be a heavier quarter for us. We do have some prepaid licenses that come through in Q1. And generally, it's been seasonally heavy and we do expect to get towards scale down as a percent of revenue throughout the year.

Joshua Shanker

And so the drag we're seeing in free cash from the first quarter, that should be recurring in 1Q and reverses as the year goes on?

Drew Wolff

Yes, the first half—I will split it into two halves. The first half of the year is a more negative cash flow part of the year, and then we have more positive flows in the back half, in general.

Josh Shanker

And obviously refer friend and recurring customers are becoming a bigger and bigger portion of the business. It suggests that the acquisition costs per pet gain through other channels is even higher than what you published. When you are thinking about spending on acquiring new pets, to what extent do you think acquisition dollars are being what spent at this point versus experimentations in trying to find new ways that may or may not be successful in acquiring pets, but worth it as long as you keep the IR profile intact?

Drew Wolff

If you could restate your question, I want to make sure I get it right.

Josh Shanker

So $303 to acquire a new pet, but it really costs very little to acquire a pet versus a refer friend, and it costs almost nothing for recurring customer, and they are coming in with new pet. There is actually a higher spend per pet through the other channels averaged across all those pets, but you're experimenting right now.

Sounds like is this hard to figure out how to acquire new pets? I'm wondering the extent to which when you look at the money you are spending, how much of ad spend and marketing spend do you think is well

spent that you're getting a knowable return on it versus experiments and trying to figure out the right way to cut the knot in half, I guess.

Darryl Rawlings

I'll let Margi answer the main part of that question.

I just want to—on the first part on your free cash flow, the rate of growth is a single biggest factor of our cash flow and the IRR, the guardrails that we run within.

But I'll let Margi answer the specifics around the IRR.

Margi Tooth

Darryl hit the nail on the head on IRR. So when we are thinking about different channels, the most cost efficient are, as you pointed out, refer a friend and recurring customers, word of mouth, which is fantastic for a brand. It allows us to really see the difference per member experience made. But when we're thinking about our spend and which channels we are investing in, we are looking across a gamut of different features and metrics of specific environment.

For example, we know that if we have a high lifetime value, we have more opportunity to spend more in that space. So if you're looking at the pure dollar amount, you are going to see that go up, but the IRR is going to be consistent. So we don't just take an overall look at IRR. IRR is coming in at day 35 to 34. We are looking at what does it mean for this particular cohort.

The teams are much like our pricing team. They are looking in a very granular level of detail. They are looking at geography. They are looking at breed. They are looking at species. They are looking at every type of element we can to get really specific with the way we are marketing. That allows us to have some areas that, to your point, are experimental.

We are not looking at a set percentage every month. But if we find that there are areas we can test in that we haven't otherwise tried before, we will go there. And that may be a lead test, it may be a conversion test. And the beauty of it is that we know what we are testing when we're testing, and we track the results so we can get better over time. And you can see consistently quarter-over-quarter, our goal is to be between 30% to 40% IRR, and the teams are very good at and very disciplined in the way they do that.

And so when we are thinking about that number that dollar, it's not about focusing on the dollar amount, it's about focusing on the IRR and that's what we're doing specifically for every pet that we are enrolling.

Joshua Shanker

One quick one in another quarter with better persistency. How far away are you from reasonable perfection in persistency?

Darryl Rawlings

I think you've dialed in a little bit late, but Margi answered the question before that, in our 60-month plan, our 99% monthly retention or persistency is our long-term goal. And she mentioned that in some areas and regions we've already achieved that. Getting any higher is really difficult with pet debt.

Joshua Shanker

Appreciate. Thank you.

Operator

Thank you. We have next question from the line of Jon Block with Stifel. Please go ahead.

Jon Block

Thanks. Hi, guys. Good afternoon.

Drew, maybe the first one, the modest 2% ARPU, I thought you explained that pretty well, talking about repricing some plans. But why the invoice growth of less than 1% year-over-year? I mean, we just hear about the inflationary environment about your increasing prices. I think Trish said earlier that the number of invoices were going up. So sort of been a good explanation on why the ARPU somewhat muted, but let's just stick with the invoice growth.

Why are you guys seemingly one of the only parts where we're just seeing such a modest climb, less than 1% this quarter, I think it was actually less than 2% last quarter. If you could expound upon that, that be very helpful.

Drew Wolff

Sure. I would reiterate. I mean, we're seeing, the cost of veterinary services in line with what the rest of the market is seeing. Whereas it's just masked by this powerful mix dynamic and we are pricing to our value proposition. So aligning that ARPU with that overall cost of claims, and pricing is just foundational in this business.

As we optimize—and I'm talking across a million subcategories, so breed, neighborhood, age. So as we're doing that, we're aligning our ARPU with our cost of care that we're seeing. So in any specific one, we are seeing pretty typical, but we're just growing now where we're getting the value proposition a lot more aligned. And you can see in the quarter: we hit 71% in aggregate, which is what we were shooting for.

Margi Tooth

And if I can add to that as well, Jon, when we think about the way the business is operating, and I mentioned it a second ago. The way everyone is communicating, if you think of pricing as the brain of the Company, what the pricing team is doing is giving the rest of the team information as to where we should be targeting.

So whereas before, if we were to take a broad-brush approach, maybe in that broad brush approach, we would be targeting people that weren't hitting value proposition, that would be changing that ARPU mix a little bit more. But now we're going after pets, we now are being priced at 71%. And when we go after those specifically, you're going to see that mixed influence directly by that.

Jon Block

Okay. I guess I could follow-up offline. I don't fully get it. I mean, you're saying the pets are going after, your install base is so big. You're not growing that fast, so it's just hard to offset it that much, because again, your base is so big. I can't see that completely being offset by the 50,000 or 60,000 pets that you're bringing on every quarter, but I could follow up offline on that.

And maybe it's just a sort of a segue into my next question. Margi, last quarter you talked about conversion rates and you said you had some challenges in the fourth quarter of '21. I don't know if you want to touch on what those challenges were, maybe more importantly, were those challenges resolved?

I think you slightly beat our gross ad number. But if you go ahead and you normalize sort of 4,000 pets that didn't occur in the fourth quarter, because of COVID, your sequential step up in gross ads from 4Q to 1Q was actually below trend line historically, usually you see a little bit of a high single digit bump and it was more maybe a low a to mid. And so maybe you can just talk on again, conversion rates, what the challenges were where the Company is trying to resolve some of those past issues. Thanks, guys.

Margi Tooth

Yes. So from a conversion perspective, we're making progress. When we think about our growth, we think about it from two angles: we think about lead generation, so how do we actually make sure pet owners are aware of us, and then we think about the conversion space. Our lead generation is outpacing in terms of progress than our conversion. Both of them are moving forward.

We have forward momentum in both areas, which is what we want to see. Phone conversions trending really well. The area that we mentioned last time was web conversion. We are making improvements. We are adjusting and we have resolved the issues that we have within our website. That said, there's a tremendous opportunity there. And when we think about the fact that we can grow our leads at the pace that we're growing, if we can get our conversion rate to move in the same direction, the same pace, we're going to be significantly growing even faster than we are today.

It's really about thinking, how do we take our new distribution channels that we've really started to open up over the last two years, make sure that we are tailoring our journeys appropriately to those specific pet owners so we're thinking about the journeys in a slightly different way, and being able to say the right thing at the right time to help pull people through the funnel.

I will say in terms of the progress we're making, we are, as I said, we are positively, but what's particularly exciting was just hired two folks that will be joining the team at the back end of this quarter, in the end of June, that will be driving specifically a focus on conversion. They come with a ton of experience and excited to have them in place so we can really start to make the most of that opportunity in front of us.

Jon Block

Perfect. Thanks for your time, guys..

Operator

Thank you. We have next question from the line of John Barnidge with Piper Sandler. Please go ahead.

John Barnidge

Thank you very much.

You were talking about international growth aspirations, and I believe it was 0.5% of revenue with development spend. Can you maybe expound upon that, the products more developed overseas? I assume you'd be going to market with a unique offering. Thank you.

Darryl Rawlings

Yes. I will pass on that. So in our 60-month plan, we're trying to look at over a long period of time doubling our addressable market. So if you look in the shareholder letter, you can see that we're now in three countries and have about 28,000 hospitals that we think is the addressable market. Over a long period of time, we'd like to get that number closer to 50,000.

That allows us to not only have a growth lever with same-store sales but to continue to add a number of active hospitals. And those two drivers have been the growth engine of this Company.

We have other areas where we're adding distribution channels to different products as additional growth levers. But international is really about increasing the size of our addressable market. And we are in early stages of trying to determine when and where we're going to be going. We hired Simon Wheeler, who joined the Company in the last 12 months. And we're making some pretty decent progress and looking forward to being more of a global player.

John Barnidge

Great. And then my follow-up question, if I could. When we had this call in February, you gave us the kind of the rate of growth in the early weeks of the quarter had reverted similar to the third quarter. I know you're holding the call a little bit early so you can have the Omaha. So could you maybe refresh us on what is the growth rate so far in the early weeks of April and in the second quarter, and how does that maybe compare to the first quarter's rate of growth on subscription pets? Thank you.

Margi Tooth

Yes. So we talk about momentum. If we look at the quarter one, January started off ahead year-over-year. February picked up even more. March was a pretty big step up for us. And that was where we saw the territory partners, the hospital visits, that lead generation from the vet channel really coming back strong. So that was a nice big step up. April is ahead of that.

We are talking well into double-digit growth year-over-year from a lead perspective. So we are excited about what we see. We feel like—we mentioned getting a lot of momentum. We are seeing that traction come through.

I think just in general the team is executing really strongly, and we are excited to see what we can do with that for the rest of the quarter. There are really encouraging signs so far.

John Barnidge

Thank you.

Operator

Thank you. We have a next question from the line of Greg Gibas with Northland Securities. Please go ahead.

Greg Gibas

Hi, good afternoon. Thanks for taking the questions.

First, now that the newer low and mid-level offerings have been out for a while. Are you seeing any movements between those offerings, either pets moving up or down?

Margi Tooth

Yes. So I think you are referring to Furkin and PHI Direct. So there are low and mid-tier products. So we are testing in Canada. The last time we discussed them, we were talking about how we are able to continue to generate new volume, which is lovely. And then we need to look at the other side of that, which is the conversion rate. We are making improvement on conversion rate actually.

We are happy with the way that that's progressing. We're probably about half way to where we want to be, which is nice to see. So every month we are getting better. We are increasing the team size and focus and dedication there, and we think that it's performing nicely.

Greg Gibas

Okay, got it. And regarding your comments on having the chance to rebuild relationships with vets now that your territory partners can kind of revisit a lot more frequently and in-person, could you kind of discuss the improvements that you are seeing, maybe it's in terms of vet channel leads or conversions as a result of that?

Margi Tooth

Yes. So our lead traffic, our (inaudible) offers is significantly up. So when we think about our lead channels, we are looking at them in terms of where does the conversation originate from. And while that has continued to be strong for us for several quarters, it always is our strongest channel, we have seen that really pick up in the last three to four months. So having the territory partners back in the hospitals, it just allows them to have the conversation, help to remind the team why it's important to talk about high-quality medical insurance, introduce the concept of insurance and just really get people thinking about it.

The other difference as well we're seeing is, because curbside is starting to pull back and people getting back into that typical workflow, it's a lot more normal for the team to start thinking about those conversations again.

The vet helps us from every single element of that journey, and the benefit of having high-quality insurance for them means that they can treat those pets far more efficiently and effectively, and do the jobs that they have been training so hard to do. So I think for us, it's critical from a lead perspective. The conversion rate is much, much more efficient as the much bigger process. People understand that when you have the authority of that veterinarian, who has been chosen by that pet and saying that this is an important thing you need to be thinking about, it just helps the conversion all the more and then subsequently the retention rate. And the experience is just much better because those hospitals have our software there.

We are paying them directly at the time of checkout. And when we do that, we see that the referral rates higher, the retention rates higher, the experience better. And for us is a far more efficient way to manage that experience to a pet owner as well.

So all-in-all, it really is the foundation of what we are trying to do with the business and just helps everything be more effective.

Greg Gibas

Okay. Helpful. And I guess you guys have really good visibility in terms of your vet partners' veterinary costs. Are you at all surprised that maybe the cost side of that isn't increasing at a faster rate, especially when we think about inflation? And if we do think about maybe your premiums catching up with that, I

know you're kind of perfecting the value proposition, that 71%, but do you kind of see premiums increasing at a faster rate than historically going forward?

Tricia Plouf

Hi, Greg. This is Tricia. I can speak to this a little bit. It's obviously something that we keep our eye on. We're looking at pricing from over a million different categories and make sure we're pricing as accurately as possible based on the data that we're seeing.

Now I will say, and Drew mentioned this earlier, what we're reporting is our consolidated numbers. When we disaggregate them, we are seeing costs going up in many of the areas in line with inflation, like you would expect. And as we price those neighborhoods, breeds, categories, we're reflecting that in the pricing that we're pushing through and maintaining that pricing accuracy.

The one thing we've been doing, and it hasn't just been in a single quarter, we've been doing it for the last couple of years, and you're kind of really seeing it in our numbers more, is really a conscious effort at that very disaggregated level to beat price as accurately as possible. And we've seen a lot of movement there, even if sometimes that means we're decreasing the price. And we talked about that more on the last couple calls. We've decreased prices in some areas where we weren't hitting a 71%; we were hitting a 65% instead of 71%. We were not returning as much value to the member as we should have, and we've updated that.

And as Margi said before, we've given that information to her team, and they have been deploying more capital in those areas to drive growth as well because we're more accurately priced. And you're seeing kind of all of that starting to come through because we've been doing that for much more than a single quarter. But to get back to your initial question, we're monitoring it, we do see it at a disaggregated level, but you've got the mix going on. And if we do see the claims data start to move, we continue to then update our pricing, which could cause premiums to go up. It's a cost-plus model. So it's a continuous process.

Greg Gibas

Okay. Got it. Thank you

Operator

Thank you. We have next question from the line of Ryan Tunis with Autonomous Research. Please go ahead.

Ryan Tunis

Hi, thanks. Good afternoon.

I might have missed it, if I did, I apologize. But just on the Chewy launch, you mentioned that's launching imminently. Could you maybe give us a little more color on what is going to be the geographic reach of that when we meet again in three months, is it five stage, 10 stage, is it slower than that?

Margi Tooth

Hi, Ryan.

At the moment we are—it's a soft launch. So when we talk about the launches, it's something that we we're rolling out slightly, as we typically will do with anything. We want to make sure that everything is performing as we expect. We're not going to go into specific details of where we're launching in the geography, but they can and tell you that the launch will roll slowly through the year.

We'll roll in state-by-state, and we'll work with Chewy to make sure that we are all aligned on what that roadmap looks like. It's moving at the pace that both of us are happy with and just move forward based on controlling that launch the right way.

Ryan Tunis

Got it. Thanks. And a follow-up, I guess, just on the annual letter. I always love the report card. I was hoping you could maybe go into a little more—you gave yourself I think two or three Cs, which sounded pretty harsh. But I was hoping maybe you could expand on—I think it might have been the new product piece in particular you gave yourself a C for. What was the thinking that went into that?

Margi Tooth

Yes. I can speak to that. So I don't if you heard earlier. Darryl, Trish and I said that on the call. And we're thinking about new products just to be more specific about what that entails. So that's looking specifically at ARPUs initiative and our GPS initiative. So the new products that are outside of the typical insurance space that we exist in. And just to recap again, as I mentioned earlier, when we think about giving ourselves a score within our 60-months plan, but for the first 12 months, we're looking at where would we expect to have been from January to December of 2021 for that first 12 months, what do we feel good about?

Getting a C isn't horrible. It's fine and fine is never the best, but it's certainly not the worst. And we think about a C, the reason we didn't score higher was because, honestly, it would've liked to have made more progress in both of these as products. But I think in general, we've learned a ton. These are, as I said, different to insurance. So we're going into spaces that we have to do a lot of deep dive, a lot of research, make sure that it's in keeping with everything that we said it was do in the 60-months plan. They're difficult to do. And we like difficult, we like hard. When we get there, it's will be worth it and it's hard to replicate.

I think, all in all, we're happy with the progress and we didn't expect to kind of come at the getting As and A pluses for everything. And frankly if we were we would've been sandbagging. So I think, in general, we feel good about a C. We've got a lot of work to do. We've still got 44, 43 months to go of our 60-month plan and we've set up well to make progress to get that a little bit higher next year.

Ryan Tunis

Got you. So it didn't include the lower ARPU products? The curiosity, when you guys—when you sat around, what grade would you have given yourself for those for Furkin?

Margi Tooth

PHI and Furkin are included in our additional insurance products. So we gave them a B minus. So above our new products, but not as good as a member experience and our intrinsic value and revenue.

Overall, they're doing well. I mean, we talk about the lead and convert side of them, the areas that we're looking to improve and conversion. We want to be able to operate that within the same guardrails as we

operate our core business. We're learning all time and making improvements all the time. And I would say that, since we put the scorecard together, we've taken another step forward, which is what we want.

And we're probably about halfway to where we would like to be before we feel good about bringing that into the U.S.. market, but they're in Canada, lots of good stuff happening. And again, another school that I suspect, if we continue with momentum we're seeing today with those two products, we'll be getting a much higher score than B minus for 2023.

Ryan Tunis

Awesome. Thanks for the answers.

Margi Tooth

Thank you.

Operator

Thank you. Ladies and gentleman, that was the last question, and that concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.