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Trupanion, Inc.

Second Quarter 2022 Earnings Conference Call

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Drew Wolff, *Chief Financial Officer*

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John Barnidge, *Piper Sandler*

Shweta Khajuria, *Evercore ISI*

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Katie Saki, *Autonomous Research*

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PRESENTATION

Operator

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

As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Ms. Laura Bainbridge, Investor Relations. Thank you. Please go ahead.

Laura Bainbridge

Good afternoon, and welcome to Trupanion's Second Quarter 2022 Financial Results Conference Call. Participating on today's call are Darryl Rawlings, Chief Executive Officer; Margi Tooth, President; and

Drew Wolff, Chief Financial Officer. Similar to prior earnings calls, 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 performance 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 reports on Forms 10-K and 8-K filed with the Securities and Exchange Commission.

Today's presentation contains references to non-GAAP financial measures that Management uses to evaluate the Company's performance, including without limitation variable expenses, fixed expenses, adjusted operating income, acquisition costs, internal rate of return, Adjusted EBITDA, and free cash flow. When we use the term "adjusted operating income" or "margin," it is intended to refer to our non-GAAP operating income or margin before new pet acquisition and development expense. Unless otherwise noted, margins and expenses will be presented on a non-GAAP basis, which excludes stock-based compensation expense and depreciation expense. These non-GAAP measures are in addition to and not a substitute for measures of financial performance prepared in accordance with the U.S. GAAP. Investors are encouraged to review 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. Good afternoon.

Q2 revenue was up 30% year-over-year. More importantly, our adjusted operating income, or the profits we earned from our existing pets before we invest in growth, grew approximately 13%, or 16% on a constant currency basis. We invested about $20 million acquiring new pets at an estimated 31% internal rate of return, an additional $2 million in development expenses and nearly $6 million repurchasing shares of our common stock.

With the strength of our balance sheet and available cash, we are well capitalized to invest in areas where we can achieve strong rates of returns. In our large underpenetrated market, investing compounding amounts of adjusted operating income at our high internal rates of return is the key to our value creation.

In the quarter, we added over 61,000 new pets. For context, this is up about 10% year-over-year and up about 14% from year-end. Growth was driven by leads and a modest improvement in conversion. In the quarter, we also soft launched Chewy, rolled out the Aflac offerings to brokers serving larger companies, and made progress internationally. We're humbled by the trust these partners have placed in us and are excited to see how these partnerships play out over time. But what I'm most excited about is that after years of shouting from the rooftops that veterinarians should be raising their prices faster, we're finally starting to see it in our data. This is very good news, most notably for veterinarians and their staff, but also for Trupanion. I'll elaborate.

Over the course of the past year, we've been monitoring veterinary inflation at an extremely granular level. Earlier in the year, we highlighted a return to pre-pandemic frequency, or the number of veterinary visits per pet for accident and illness. In the past month or so, we've also begun to see an accelerated increase in the size or dollar amount of the average invoices we are receiving. The combination of invoice size, what veterinarians charge, and the frequency of accidents and illness related to veterinary visits makes up our cost of claims. For the last 22 years, this veterinary inflation has increased approximately 5% to 6% per year for Trupanion members.

Today, we're seeing the overall cost of care for many veterinary hospitals increased 8% to 12%, or approximately twice that of the historical rate. We expect and hope this will continue to increase in the range of 10% to 15% for at least the next three to four years so veterinarians and their staff can be paid appropriately and in line with other medical professionals.

Our 20-year track record shows that we're pretty good at pricing in line with our value proposition. More important than that is hitting our target for adjusted operating income. Doing both is not easy, and the team will need to remain focused and deliver. It is important to note our mix of business will continue to influence our reported ARPU, which is a blend of all subscription pets.

We are not saying that people should model or expect blended ARPU to grow 10% a year. For example, a higher mix of new pets (phon) means a lower blended ARPU. More pets enrolling through the worksite will mean a lower blended ARPU. More pets enrolling from parts of the world with lower veterinary costs will mean lower blended ARPU. Our blended ARPU is simply an output. For that reason, we believe our ability to operate the business effectively can and should be measured by our adjusted operating margin.

In the quarter, our adjusted operating margin was approximately 13% compared to our annual target of 15%. As Q2 shows, we don't always time things perfectly, nor would I expect us to. Drew will elaborate on this more momentarily. That said, if I don't see an expansion in our adjusted operating margin in the back half of the year, I would be disappointed.

Short term, margin compression is the evidence of additional inflation. This environment creates a unique opportunity for Trupanion. With our cost-plus model, rising cost of veterinary care drives higher ARPU and pet lifetime value over time, increasing our allowable acquisition spend and supporting continued investment in the category.

With rising cost of care also comes a greater need among pet owners to find a solution to help them budget for the unexpected costs of accidents and illness. That is why we exist, and I believe and expect that we are and will continue to be exponentially better, faster, and more accurate than others. In fact, Trupanion's decades of growth has benefited from the cost of veterinary care outpacing the growth of pet owners' bank balances.

Now let's pull back a little and look at the big picture. Parents universally agree that food, shelter, quality health care, and love are the bare necessities for our human children. For the majority of pet owners, and for Trupanion members in particular, our four-legged children have the same basic needs. We believe the combination of these bare necessities currently make up less than 50% of a pet owner's annual pet spend, with veterinary health care being approximately a quarter of a pet owner's existing share of wallet. If veterinarians were to raise their prices in line with my hopes and expectations, this would not necessitate the need for individual households to increase their monthly pet spend. Said another way, pet owners could reallocate spend from discretionary items like pet clothing and doggy day care if required.

Already, our category is accelerating, and this is before pet owners have started to feel the impact of a step-up from the historical 5% to 6% increase in veterinary cost. Last year, the category added over $650

million in revenue, up from $450 million in the prior year. We believe Trupanion led the category, adding about 30% of its growth.

I'll now turn the call over to Margi, Trupanion's President, to talk more specifically about the significant opportunity ahead of us.

Margi.

Margi Tooth

Thank you, Darryl, and good afternoon, everyone.

I want to take a moment to elaborate on Darryl's commentary around why our trusted partnership with veterinarians is critical to the opportunity we have in this large underpenetrated market. There are times when something happens in the world that exacerbates the problem we, Trupanion, are trying to solve, when we face an even greater duty to step in and make a difference.

Today's inflationary environment with mounting economic uncertainty and increasing pressure on our veterinary partners is one of those times. We partner with veterinarians to ensure that pet parents are able to provide for their pets unexpected care. Today, those trusted stewards, our veterinary teams, are struggling more than ever before. Burdened with the rising cost of care, overworked, tired and stressed, veterinarians have been pushed to the point of burnout. Couple this with a backdrop of rising inflation and the fact that, today, the majority of pet owners cannot afford more than $1,400 in unexpected veterinary costs. The threshold of economic euthanasia is that low.

The rising cost of care will make it only more difficult for the average pet owner to budget for the unexpected, and veterinarians still need to raise their prices. We're starting to see early signs of this increase come through in our data, but it's not enough, and we need to be prepared for this to be much higher.

As Darryl noted, in the next three to four years, veterinarians are going to need to raise their prices in aggregate by 30% to 50%. Too few pet owners can afford unbudgeted veterinary bills today. Fewer will be able to in the future. With this as the backdrop, let me take a moment to walk you through how our value proposition is more relevant than ever.

To start with, we help pet parents budget for the cost of unexpected veterinary bills for the life of their pet. We make it affordable for our members by breaking the cost of care into small monthly payments they can adapt to. Because of our unique pricing at the age of enrollment, we are the only player to offer lifetime coverage. The monthly cost doesn't increase because the pet had a birthday. This is unique in the industry globally.

As vets raise their prices, which they will do, our vertical integration local support through our territory partners, 20-plus years of veterinary data and unmatched team of actuaries positions us ahead of any other player in the industry. Moreover, we are ending the need for reimbursement. Pet owners must understand how paying the vet directly means an end to reimbursement. Our solution has never been more relevant. High-quality insurance should not leave you waiting for a decision. Trupanion does not.

We are paying more veterinarians directly than ever before, enabling them to operate more sustainable businesses. No more time spent on estimates or fees for credit card payments. Year-to-date, total invoice dollars paid directly to veterinary hospitals were up 20% over last year. The majority of these had payment approval in mere seconds, comparable to, if not quicker than, that of a credit card. We want to

empower veterinarians to offer and practice best medicine, removing the emotional toll of heart-wrenching decisions forced by financial constraints.

Finally, we will continue to be there 24/7, 365 days a year for both the lucky and the unlucky pets. We remain steadfast in our mission. Through our business model, we're able to reach and educate veterinarians and pet owners alike to offer high-quality medical coverage for the lifetime of a pet and to change the paradigm of pet health forever.

Drew.

Drew Wolff

Thanks, Margi, and good afternoon, everyone.

Today, I'll share additional details around our Q2 performance, as well as share some thoughts on how we're tracking against our annual goals. Total revenue for the quarter was $219.4 million, up 30% year-over-year, driven by strong pet additions and sustained high levels of retention in our subscription business, along with continued growth within our other business.

Within our Subscription Business segment, revenue was $145.8 million, up 21% over last year. In the quarter, the U.S.-to-Canadian foreign exchange rate had a larger than typical impact. On a constant currency basis, subscription revenue would have been $147.3 million. Total enrolled subscription pets increased 20% year-over-year to over 770,000 pets. Average monthly retention, which is calculated on a trailing 12-month basis, was 98.74%, equating to an average life of 79 months. This is compared to 98.72%, or an average life of 78 months, in the prior year period.

Monthly average revenue per pet was $64.26, an increase of 0.9% year-over-year. On a constant currency basis, monthly average revenue per pet increased 1.8% year-over-year and continues to be impacted by the mix of business dynamics that we've previously discussed.

Our loss ratio expanded 170 basis points from the prior quarter to 72.8%. While some level of variability is expected, this move is larger than typical and the result of three factors all occurring in the same quarter. I'll explain.

First, frequency was the largest driver of the increase in our loss ratio, as we discussed at the shareholder meeting. Secondly, elaborating on Darryl's point regarding timing, we had higher claims processing costs as we continued to staff up for business expansion that will yield cost efficiencies in the back half of the year as we bring on new business. Finally, at the end of the quarter, we saw an uptick in severity of claims.

We will continue to monitor data at extremely granular level and adjust pricing as needed in order to hit our target margins. As a percentage of subscription revenue, variable expenses were 9.9% in the quarter, reflecting continued investments in our member experience, including additional staffing in advance of new product launches. We expect to leverage these pre-revenue investments now that we're actively in the market.

Fixed expenses were 4.3% of revenue. After the cost of paying veterinary invoices, variable expenses and fixed expenses, we calculate our adjusted operating income. Relative to Q1, we took actions to drive operating leverage to partially offset the increase in our loss ratio. Nonetheless, our subscription adjusted operating margin was 12.9% in the quarter, down from 13.8% in the prior year period. We continue to monitor veterinary inflation and are working to push pricing through based on current rates of inflation.

With additional cost actions, we expect to drive sequential expansion in subscription-adjusted operating margin, both in Q3 and Q4, and in Q4 in the range of 14% to 15%.

In dollars, our subscription business delivered adjusted operating income of $18.8 million, an increase of 13% over the prior year period. The aforementioned year-over-year change in foreign currency impacted adjusted operating income by approximately $600,000 in the quarter.

Now I'll turn to our other business segment, which is comprised of revenue from other products and services that generally have a B2B component and a different margin profile than our subscription business. Total revenue was $73.6 million. Compared to the prior year quarter, this is an increase of 54% year-over-year, reflecting an increase in pets enrolled within this segment.

Adjusted operating income for the segment was approximately $2 million. As a result, our total adjusted operating income was up 13% over the prior year period to $20.8 million. While we do expect some variability quarter-to-quarter, we're running behind the 25% annual growth target outlined in our 60-month plan. I will discuss this more momentarily.

During the quarter, we invested 18% more year-over-year, or $20.2 million, to acquire 61,000 new subscription pets. This resulted in a pet acquisition cost of $309, an estimated 31% internal rate of return for a single average pet.

We also invested $2 million in the quarter on development costs. These are pre-revenue, non-capitalized costs related to new products, channels and international expansion, which we expect will add additional long-term growth levers. As a percent of revenue, development expense was 92 basis points in Q2, a step-up from recent quarters, reflecting activity ahead of the Chewy and Aflac product offering launches, as well as some additional international investment.

Now that we're in market with these products, we expect to drive development expense back toward 0.5% of revenue by year-end. This resulted in an Adjusted EBITDA loss of $1.7 million compared to Adjusted EBITDA gain of $0.2 million in the prior year quarter.

Interest expense totaled $1.2 million in the quarter. Total stock-based compensation expense was $8.5 million, in line with our expectations. We also repurchased approximately $5.8 million in our common stock in the quarter. As disciplined allocators of capital, we will seek opportunities to invest where we can find attractive returns. This includes repurchasing our own stock during periods when we believe our market valuation reflects a deep discount to estimated intrinsic value. We will do so in a prudent manner, always balancing our capital needs with our growth projections.

As a result, net loss was $13.6 million, or a loss of $0.33 per basic and diluted share, compared to a net loss of $9.2 million, or a loss of $0.23 per basic and diluted share in the prior year period.

Turning to our balance sheet, we ended the quarter with over $243 million in cash, cash equivalents and short-term investments, which is up from approximately $213 million at the end of the last year. We held approximately $54 million in debt, with $90 million available under our long-term credit facility. With the strength of our balance sheet, we believe we can comfortably fund several years of accelerated growth while also maintaining flexibility to repurchase shares or pursue strategic M&A when we believe the opportunity is compelling.

In terms of cash flow, operating cash flow was negative $3.1 million in the quarter compared to negative $2.2 million in the prior year period. Capital expenditures totaled $3.9 million in the quarter, and as a result, free cash flow was negative $7.1 million.

As highlighted in our 60-month plan, it is our goal to deliver 25% year-over-year growth in adjusted operating income. Last year, the first year of our 60-month plan, adjusted operating income grew 37%. Currently, we expect to grow adjusted operating income in the range of 15% to 20% for this year.

With the backdrop of rising cost of care, growing need for Trupanion in North America, additional distribution channels, products, and international expansion, we believe 25% growth in adjusted operating income remains the right target. This will continue to be our goal for 2023 through 2025.

Now I'll hand it back over to Darryl.

Darryl Rawlings

By the numbers, it was a mixed quarter for execution. As I've said before, execution is tough. But when I look at the thousands of public companies one can invest in during times of uncertainty and inflation and given current market sentiment, I believe our love affair with our four-legged family members, our large and underpenetrated market, high retention and lifetime value of a pet make us stand out from the crowd.

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

Operator

Thank you. Our first question today is coming from John Barnidge of Piper Sandler. Please go ahead.

John Barnidge

Thank you very much.

I wanted to talk about the subscription loss ratio. It came in about 170 basis points above the target of 71%. I know you talked about getting down to the 14% to 15% AOI margin for the fourth quarter, but I know, Drew, you had talked about some scale economies would maybe offset some of that elevation in the loss ratio. I wanted to circle back to that target. Are you expecting to exit 4Q '22 close to 71% again?

Drew Wolff

Yes, we're expecting to get closer to 71% with additional cost action across fixed variable and loss adjustment expense to produce that 14% to 15% adjusted operating margin.

John Barnidge

Okay.

Then what was curbside versus a quarter ago in vet clinics, please?

Drew Wolff

Could you repeat that again?

John Barnidge

Yes. Curbside-only at vet clinics. I know that's a dynamic that certain vet practices have decided to keep even in a post-pandemic world. Can you maybe talk about vet hospitals or clinics that you're in that

maybe have your software? What percent of those remained curbside-only versus a year ago, or a quarter ago? Thank you.

Margi Tooth

Hi, John. It's Margi.

Curbside definitely is still—we see it in evidence across hospitals across all of our markets, so obviously, it's more the exception than the rule, certainly than a year ago. What hospitals have done is they've adapted their processes, as we've seen from (inaudible), to make sure their workflow now can bring in the introduction of the opportunity to talk about the high-quality medical insurance. We haven't seen an increase in the number of people leveraging curbside recently.

What I will tell you is our software, our vet portal, as we now have been referring to it, is increasing, so our utilization rate throughout the quarter went up 20% year-over-year. We're seeing more vets with not only taking the software, adopting it. They're using it more often than they were before. People are now getting back into the hospital, so curbside is very much less of it. Like I said, an exception as opposed to the rule at this stage.

Darryl Rawlings

Yes, just one thing to add on that, John. Curbside is one thing that affected pet owners, and as Margi said, that's largely diminished. The bigger part for us is our territory partners. We're often not able to walk into the hospitals, and they're now able to walk through the doors, and that's been a big benefit to the Company.

John Barnidge

Thank you for that.

Maybe one last question, if I can. Are you seeing any sign, in the wake of inflation, that insurers are choosing to maybe move from lower deductible, higher monthly ARPU to higher deductible, lower monthly ARPU?

Margi Tooth

I can certainly start that. I don't know if others want to add to it. We've actually been looking at our deductible trend, as we always do across the board for everything, on a very regular basis. Our deductibles have actually been trending down. We've seen that coming through throughout the quarter, the back end of Q1 into Q2, so that means both on phone and web people are taking a lower deductible, which is obviously contrary to the high deductible that you just questioned about there.

People are seeing the value. We've said before that people are very value-sensitive, and there is no difference across markets or different channels. Usually, that deductible point is coming down.

John Barnidge

Thank you very much.

Operator

Thank you. The next question is coming from Shweta Khajuria of Evercore ISI. Please go ahead.

Shweta Khajuria

Okay, thank you. Let me try a couple, please.

What does the adjusted operating income growth rate guidance include in terms of the cost? Could you please break it down in terms of your expectations, whether it is investments, loss ratio, etc., just a little bit more?

The second question is, how should we think about the contribution from the lower-priced products in the back half of this year, as well as contribution from Chewy partnership and other incremental growth channels? Thank you.

Drew Wolff

Sure. I'll start on the first question and hand off the second one. But the guidance on adjusted operating margin includes action across the board. We're going to have to—our loss adjustment expense will have to come down. We'll get additional scale on fixed and some work in variable, as well as taking pricing action on the revenue side to produce—get back towards our target loss ratio, and that's embedded in the 14% to 15%.

Margi Tooth

Okay, and then the second question. Hi, Shweta. It's Margi.

In terms of contribution from lower class products in the second half, so PHI and Furkin are the products that we have in market right now that have been everything we've expressed before. We've been pretty disappointed with the overall progress of those products in general.

We have changed our overall positioning in terms of having two general managers that now are responsible for having that growth. We don't anticipate significant impact from them in the back half of the year. What I will say, Chewy and Aflac, they've launched a market where we're very happy with the overall—the early stages of that. They're two products that we're very honored, and I think Darryl touched on this in his prepared remarks. We're humbled by the fact that we've got the trust of these two brands to be able to partner with Trupanion.

We don't anticipate seeing anything more than single-digit growth in the back half of the year with these two products. As a reminder, the monthly subscription revenue product, we're not going to see the bulk of that impact coming through as we just start to get those rolled out, early stages, but we do anticipate seeing some impact, albeit minimal in Q3 and Q4.

Shweta Khajuria

Okay, thank you.

Operator

Thank you. The next question is coming from Josh Shanker of Bank of America. Please go ahead.

Joshua Shanker

Yes, thank you for taking my question.

During the Annual Shareholders Meeting, you threw out a statistic in about May installations, 352 software installs in May. I don't think you want to go updating that number every month, but maybe we can talk about whether that trend is continuing, whether that was a blip or not. You mentioned briefly in one of the questions, but what's going on in terms of face-to-face interactions? How is that trending with the territory partners in the veterinarian clinics?

Margi Tooth

Yes. You're right, Josh. We won't go into details about how that number, that 352, is continuing to scale, but I can tell you it continues on that same trajectory. We've been very happy to have the vet visits back at the levels that we were seeing back in 2019. We have more people in the field than we ever have had before, and they can now walk in the doors of hospitals and rekindle those relationships they had face to face.

What we're seeing, a result of that, not only is more people adopting the use of our software, using it on a regular basis. We're also seeing an increase in leads volume and paying their veterinarian directly at the time of checkout, which we know resolves a lot of problems, as we referred to in our prepared remarks.

When we think about a face-to-face interaction, what that does is it just reinforces the need for high-quality medical insurance and just reinforces how we can be there at the time of need, whether it's boots on the ground locally, which has helped to understand that market. That information helps to inform our pricing team. It also helps to drive our higher lead volume, which in turn has a high conversion rate, which means we have a more efficient PAC, so that's why it will start to really come together nicely.

We're very happy with the fact that we've been able to get back into the hospitals. That trend started at the back end of Q1, has been maintained through Q2, and we continue to see that happening in Q3 as well.

Darryl Rawlings

Yes, and I'll just add that with the—all of the general talk of inflation for non-veterinarian and it being even more acute in the veterinary space and us seeing that in some of the numbers, it gives real strong talking points for our territory partners, creates a level of urgency. Having them walk through the door has been great for the business and super happy to have them back in the field.

Joshua Shanker

If I look at the IRR on customer acquisition cost at 31%, getting close to your lower bound of 30%, which suggests maybe the efficacy of customer acquisition spend is weakening. Look, the growth is great in terms of subscription pets, but do we get to a point—are we at that point maybe where some of the ad spend doesn't make as much sense, some of the marketing spend, because you just can't get that 30% return?

Margi Tooth

IRR, I've got it as between 30% and 40%, and that doesn't change quarter-over-quarter. We were at 31%, as you commented, and when we think about the impact of that, still margin compression through the quarter. What we were doing as we saw that coming through, the team's reacting. They're communicating with each other and adjusting their spend profile, so it did put pressure on it and bring it closer to the 30% mark. Overall, though, when we look at our channels and the efficacy, it's strong as ever. The volume is strong. Conversion rates are high, so we don't have any concerns there.

Joshua Shanker

Thank you for the answers.

Operator

Thank you. The next question is coming from Katie Saki (phon) of Autonomous Research. Please go ahead.

Katie Saki

Hi. Thank you. Good afternoon.

Inflation is rising and your ARPU isn't growing much sequentially, so can you just walk us through why you think you'll get back to a 71% loss ratio?

Tricia Plouf

Yes. Hi, Katie. This is Tricia. I can talk about this one.

At a high level, what ARPU shows up on our consolidated financials is an output, and it's an output of pricing to as close as we can to that value proposition, that 71% like you mentioned. Now, day-to-day, and I talked about this at a geography level at the shareholder meeting, we are constantly looking at the data at a granular level—geo, neighborhood, breed, age of enrollment—and updating pricing very frequently.

We have many regions and neighborhoods that we're pricing that are receiving increases in the 5% to 10% range, some higher than that. Now we have some regions where we actually are running below our loss ratio target, and so we've been decreasing those prices. The ARPU that you see on our financials is the blend of that and where we're really targeting is to hit the target of 71%, and then, as Drew mentioned, have that flow through then to getting us closer to our 15%.

Now, based on the data that we see, we are increasing the prices in more areas than we were six months ago to keep up with these rising costs. Not only the frequency of their invoices, but now, as Darryl mentioned, in some areas—not all, but in some areas—we are seeing average invoice size start to go up more than we have in the past.

The key for us is we'll never be absolutely perfect, but we are looking at this at a very granular level, more multiple times a month. We have pricing action going through at all times. About one-twelfth of our book every single month sees price changes at a granular level to get them closer to our value proposition. We have pricing that is going through currently, and then we're looking at additional filings to reflect the inflationary period that we're seeing as well to get us closer. We've been doing this for a long time, and so we feel confident while timing may move around, that we can absolutely get back on track to our value prop.

Katie Saki

Got it.

As a follow-up, with inflation running, say, 8% to 12% in the vet channel, can you give us an idea of what Trupanion's rate increases are looking like today on a nationwide headline rate?

Tricia Plouf

Well, at a macro level, we're seeing in the first half of the year our ARPU is going up 1.4%, and our claim per pet is going up 1.5%, so we've been doing—while there's some timing variation between quarters, we've been doing a good job of keeping that up, although we need to make up about a 1% delta. Now, in general, when we're filing the rate increases, as I said, the vast majority of our book is seeing rate increases between 5% and 10%. It's just offset on a blended basis with certain regions and breeds that we're decreasing prices, so that's where you get the blend. But when we peel back the onion and look at it, we are putting through larger rate increases that you would expect in many areas.

I'll also say that some of the rate action that we've taken over the past two years to decrease prices in certain regions to get closer to our value proposition, we are at the tail end of that, so really think about it a little bit more as a reset to being closer to our target, which is the right thing to do. As we mentioned, being closer to our target has enabled those regions to grow faster, because it's a better value proposition as well. But you'll see now that what goes through in the future doesn't—most likely would not reflect so many rate decreases as opposed to keeping up with inflation more on a blended basis.

But I would add it really is important to look at these various metrics, because as we add more products into the mix, as certain geographies grow faster or slower, you're going to see more of a blended ARPU. If we start growing faster in products that have a lower ARPU hypothetically, that would impact our overall blended ARPU as well, so mix of business is key here as well.

Drew Wolff

Yes. Katie, I mentioned in my opening remarks our blended ARPU is an output. It'll be what it will be. We hope that workplace and a bunch of other places really can start to make an impact in the back half of the year. Some of these we're expecting that lower ARPU, so on a blended basis you may see that it's not tracking what you might otherwise expect with these inflationary comments. What matters is to look at our adjusted operating margin, and that's our ability to execute. Then in our comments on here we're expecting to see some margin expansion in the back half of the year, and if we execute well, that's what you'll see.

Katie Saki

Got it. Thank you so much for the answers.

Operator

Thank you. Our next question today is coming from Maria Ripps of Canaccord. Please go ahead.

Maria Ripps

Great. Thanks so much for taking my questions.

Darryl, if we are indeed going to see 10% to 15% increase per year in like-for-like cost of vet care over the next three or five years, I think you said, and that obviously compounds over the years, how do you think about your capacity to increase prices for your members without impacting retention?

Darryl Rawlings

Well, we've been doing this for over 20 years, Maria, and we know and we've been tracking in our shareholder letter. If we're seeing rate increases in the 10% to 15%, our retention rates and conversion rates remain the same. When we see it over 20% year-over-year, we see it degrade slightly. When I said it's going to be 10% to 15%, that's what I'm hoping the veterinary community will do so that they can pay their employees and the veterinarians appropriately compared to other medical professionals. I'm not guaranteeing it's going to happen, but we certainly hope that they will. We know that members can afford to pay for that care when it's budgeted and broken into monthly payments, and we have no concerns with it and excited to see if it happens.

Maria Ripps

Got it. That's very helpful.

Then, secondly, on your recently announced partnership with ezyVet, could you maybe provide some additional context on how this offering is different from the core software integration? What overhang is being addressed by this partnership so that thousands of additional hospitals are now able to integrate the software?

Margi Tooth

Hi, Maria. It's Margi.

The partnership with ezyVet is essentially a full integration within their overall platform within the practice management system. What that does is many folks migrated to ezyVet a couple of years ago that had been working with Trupanion historically, and we didn't have that full integration embedded. Now we do have, so we have access to hospitals we've historically worked with. You do have quite a lot of members, Trupanion members, as well as those that have on-boarded with the cloud-based software that ezyVet is. It gives us access to hospitals that have partnered with us for a long time, and some of them are very large, and some are new.

When you think about our practice management approach and how our penetration rates are increasing across the North American market, ezyVet is one that really gives us access to an awful lot more hospitals. It just enables us to be able to pay the vet directly and really solve that problem, and very much with the veterinary profession, that we can offer them a solution that they didn't otherwise have if they had ezyVet previously. It just reinvigorated those hospitals that are already supportive of us.

Maria Ripps

Got it. That's very helpful. Thank you for the color.

Operator

Thank you. Our next question is coming from Jon Block of Stifel. Please go ahead.

Jonathan Block

Thanks, guys. Good afternoon. Maybe just two for me.

Just first on the gross-adds. I just want to look back the past six quarters or so. It looks like the gross-adds trend line has somewhat flattened out, 55,000 to 58,000, give or take, for 2021 normalized for a quarter, and then to 61,000 in the first half of '22. Darryl, there's that anecdotal chatter that pet adoptions might be starting to subside from, call it, pandemic highs. I think a good amount, maybe 70% or 80%, of

your gross-adds come from puppies or kittens. Just would love your thoughts on that and, more importantly, that trend line going forward, I think, as a growth company. People really have that inflecting in '23, '24, so how do we think about that gross-add trend line going forward, while arguably adhering to your 30% to 40% IRR?

Darryl Rawlings

Jon, I think when I look at—we're a monthly recurring revenue business. If I think about our total subscription pets, which is how we get our revenue, if I look at it over a period of time, '17, '18 and '19 our growth rates were about 15%. In 2020, it grew to 17%, and then '21 and '22 it's going to be between 21% and 22% in total subscription pets. Now, with monthly recurring revenue, sometimes you're accelerating new faster, sometimes retention is faster or slower. But when I look out and go into '23, '24, '25 for the Company, we not only have the strong growth that will be driven by the veterinary inflation and our territory partners walking through the door.

In our 60-month plan, we talk about these additional channels that are coming online, a couple that launched last quarter and will start to make an impact in Q3 and Q4. I'm really excited about the work we're doing internationally that we expect will start to take hold in '23 and '24, as well. As a company, when I look at it, I look at the total subscription pets, but really, I monitor my year-over-year increase in adjusted operating income. Can we compound that?

Now, as I've said before, our goal is to grow that 25% a year for each year in our 60-month plan, which started in '21 and will end at the end of '25. In the first year, in '21, we grew that greater than 25%. We were over 30%. As Drew mentioned, we think our adjusted operating income, which is the closest proximity to intrinsic value, will probably not hit our growth target. It'll be probably 15% to 20%, but we do think that, as a goal, internally as a company, 25% will be the goal we'll be setting in '23, '24 and '25. We'll see how we do. Some years, we might grow faster. I've mentioned in my shareholder letters anytime we're growing 20% to 25%, as a shareholder I'll be thrilled. I'm happy there. If it's over 25%, I'm ecstatic, doing backflips. I think we've got a lot of things in the pipeline and a lot of things that have been slow, so I'm super encouraged about the future.

Margi Tooth

Can I add as well to that, Jon, just in terms of the future? Just when we think about the vet traffic specifically and what we've been able to do, we're coming off the back of a tough comp year-over-year with the overall pet count. But to Darryl's point, we've seen things moving in a very positive direction from an overall trend, for both retention and acquisition: being back in the hospital, being able to offer some very high-quality products through the vet channel, having our territory partners out there. This is a market that we trust implicitly, the partnership with the veterinarians, being able to offer them unrivaled levels of support and service at a time when they absolutely need it to be pushing the strength that we've been talking about from an inflationary perspective.

I am very confident in the numbers that we're seeing coming through at the early stages of Q3 and the back end of Q2. That means that the vet channel traffic, which is our real driver of the growth that we see both from a retention and acquisition perspective, is looking very strong and exciting more than ever.

Jonathan Block

Got it. Thanks for that color. Very helpful.

Then, the second question, Darryl, may be a little long, and it's going to end with more of your opinion on something, Darryl. But ARPU is up 1%-ish year-over-year, so modest, well below the rate of inflation,

which I think you said is now 8% to 12% in the veterinary world. Just trying to catch up on that on the pricing, I get it, but you said, "Hey, look, there's not a direct walk across to ARPU because there's a million moving parts, and part of that is mix." I just want to be clear because I've been confused in the past. I think what you were saying, Darryl, when you were giving examples is that the newer pets coming on, maybe puppies or kittens or alternative channels, those are lower ARPU pets. The ones that are coming on are, call it, below corporate ARPU. Let me pause there. Is that correct?

Darryl Rawlings

Well, there's two things I want to just correct, Jon. I said there's 8% to 12% increases in some of the veterinarian hospitals, not all. We are starting to see larger—and that's not on invoices paid. That's on total invoices. The first place we look for inflation is, of all the invoices we're seeing, are veterinarians taking larger price? Historically, for the last 20 years, that's been about 5% to 6% for insured clients with Trupanion. The total invoice dollars are going up 5% to 6%. There was a question earlier today saying, has deductibles gone up? They haven't. They've actually been going down. But if deductibles were going up, that would change your cost of claims and then what we're charging as well.

The blended business really is an impact. It is often true that we are largely enrolling younger pets. That has been the same for year after year. But if we take a city, for example, and let's say in a city had two—we cut the city in half, and half the city we're running at an 80% loss ratio and the other half of the city we're running at a 60% loss ratio, but in general we had 70% on average. What would have been happening before is we would have been growing faster where there was an 80% and slower when there was a 60% than if we made them both 71%. You see an accelerated growth in the lower priced one, the lower priced neighborhood, and you see a slowdown in the higher priced neighborhood in comparison to what you were doing beforehand.

Now, Progressive is a company that—an insurance that was more accurately pricing risk than other insurance companies for many, many years, and their mix of business would be different than a different insurance company. Our goal is to be a disciplined grower to get strong IRRs, and as we continue to refine our pricing, our blend is changing.

Now, in addition to that, with Chewy and Aflac and some of the other things in our 60-month plan, as well as international expansion where we'll have lower veterinary costs on average, that's going to continue to influence blend. As I mentioned in a couple of calls before, our blend is really going to be an output. We were pretty easy to predict 15% year-over-year growth in '17 in subscription pets, 15% in '18, 15% in '19. You added about 5% in ARPU, and you got about a 20% increase in revenue. We had adjusted operating margin growing at a greater rate because we had margin expansion. Right now, it's hard for us to predict what our blend will be, but to see if we're good managers of our business, it's really about that adjusted operating margin.

You are right. There are a lot of things at play, and there's going to be more things at play in the future, and monitoring that adjusted operating margin is what I look at. Then, I look at the year-over-year growth of the adjusted operating income, and then how many dollars are we able to deploy at outsized internal rates of return, which I define at anything over 30%.

Jonathan Block

Okay.

Maybe I'll follow-up offline, but just more of the opinion one was, Darryl, just at a high level, when you're running that internal rate of return, why is that dictated by the ARPU of the entire subscription base rather than the cohort that you're bringing on in the current quarter? In other words, you're doing the PAC

dollars, right? But the internal rates of return are predicated on is that a cohort that is a $50 ARPU bringing on the books, or $75? Why is it always run over the entire 770,000 pets that are already on the books? Hoping that made sense. If not, we could take it offline, but just wanted to throw that out there from more an opinion standpoint.

Darryl Rawlings

Well, the IRR is actually not driven by ARPU. It's driven by the adjusted operating income or margin. You take the adjusted operating income and you multiply it by the number of months. That gives you the stream of cash flow. Then, you say how much are you spending? What we use on calculating it is what is our blended adjusted operating income for all of our pets when we report it? But in aggregate, when we're behind the scenes, we're spending much less for a cat than we are on a dog.

The way that we calculate the internal rate of return does not assume that we're going to have larger adjusted operating income two, three, four, five years in advance. It's actually conservative and understated, assuming that on average the adjusted operating income is going to go up over time. But that's how we run it, and if you have further questions we can jump on it offline.

Drew Wolff

Jon, also when we set that up, it's important that people can replicate our numbers. It was set up so you could take our financials and back into that without having the new ARPU, so there's another reason it was set up that way.

Jonathan Block

Yes, I get the transparency. I just want to know if you're spending the $300 pet to bring on $50 cohorts or $70 cohorts. I think that's ultimately what matters, but I get it in terms of investors being able to run it. All good. Thanks, guys. I'll follow up.

Drew Wolff

Yes.

Operator

Thank you. The next question is coming from Elliot Wilbur of Raymond James. Please go ahead.

Elliot Wilbur

Thanks. Good afternoon.

This may have been asked earlier. I might have just missed it, but just want to get your general sense of trends in ARPU and what the impact would be on churn. More specifically, thinking about the two buckets at each end, bucket where historically you've not experienced price increases, which I think about 25% of your book, and then smaller bucket where there's been in excess of 20% price increases. Curious as to whether or not you think that change in either of those buckets could have a more outsized impact given that we're obviously looking at much higher overall rates of inflation.

Darryl Rawlings

Yes, Elliot, it's a good point for people that haven't read the shareholder letter, but we report year after year about where our churn comes from and how it goes through. I'm not sure that how you articulated it is exactly accurate. We have, largely, three buckets that we report on. Those are new pets, and those new pets have not yet ever had a rate change. That's actually our lowest retention, so we have the highest churn there. Those are people picking tiers, people that sign on and their dog was currently sick and they were disappointed we didn't cover preexisting conditions. It could be people that were going to get a spay, neuter, or regular wellness and were confused on what their coverage was. That's in that first bucket. That is our highest churn level.

The second bucket is where the majority of our pets are, and they're seeing rate changes that are less than 20% a year. It could be the rates are going down, so they're going up 19%. That is our highest retention.

Then, we also have a bucket where people are seeing rate changes greater than 20%. That's the medium bucket of churn for us, and what you'll see over time is that third bucket will become a smaller percentage, unless veterinarians start to increase their rates not what I'm hoping 10% to 15%, but if they were to increase at 25% year-over-year. But as long as it's under 20%, you can look at historically how we—what our churn rates have been, and I can tell you we are at all-time retention right now, that we reported on 98.74%, I believe. Our conversion rates are slightly up. Referral and add a pet is also at record numbers of growth. Once again, we don't see the customers that we attract as being price-sensitive, but they are certainly value-sensitive, and in times of uncertainty, of high inflation, the need for our product is greater than ever.

Elliot Wilbur

I want to ask a question on the PAC number in the quarter and trends in PAC. Maybe just possible to give a little bit more granularity on what's driving that? I think you've provided some detail in the past and given us a rough split between allocation, between lead generation and conversions and more dollars going to conversions over time. Wondering if the relative rate increase in those two categories is essentially equal, or you're seeing the cost of conversion go up at a higher rate than lead generation, but maybe just a little bit more insight into the increase in the PAC number this period.

Margi Tooth

Yes. Hi, Elliot. It's Margi.

When we think about PAC in general, if we look at it over the last few quarters, it's been relatively flat. In Q4 of '21, it was $306, Q1 was $301, Q2 was $309, so when you think about that overall, there's really very little movement between the quarters. As we mentioned before, the real guiding light for us is those guardrails for internal rates of return. They've been between 30% and 40% at any given point in time. Our overall split between the convert and retention, so we do have an element of retention, which is that first year that Darryl alluded to just now, just a reinforcement of the value proposition just after purchase. It all goes into PAC.

This is a fully loaded cost. As a reminder, this is everybody that works within our acquisition space. That lead and convert, it hasn't really shifted significantly. If it has, it's by a couple of points. We're constantly looking at how do we make sure that we are—just as we do from a pricing perspective. We're focused on the right message at the right time with the right combination of different attribution points, so there's a number of different elements to a journey that will pull someone through the funnel. If you've got a vet lead, for example, we're going to see the overall lead cost is going to be the bulk of that. The conversion is very simple. It's very straightforward. It's a much cleaner lead for us because it's a stronger referral upfront. Similar with referral, (inaudible) you have different regions will have different mixes.

In general, it hasn't changed. They're all being as efficient as we would want them to be in various spaces, and we'll push hard on certain areas than we will on others. Like we said when we talked about internal rates of return specifically for this quarter, we really saw that pressure coming through from a margin compression point of view. We want to make sure that we're always adhering to those guardrails, which is where you see that looking like it's towards 31% as opposed to the midpoint.

But PAC, in general, just really isn't moving a great deal over the last three quarters, as I mentioned. The teams continue to invest at similar levels between lead and convert, and we haven't seen that shift as well, particularly.

Elliot Wilbur

Okay. Then, last question for Drew. Drew, you mentioned the uptick in the severity of claims. Was that just within the realm of the ranges that you see historically? Anything specific in terms of territory or what may have driven this period that led you to call that out?

Drew Wolff

Yes. As I mentioned, at the shareholder meeting I talked about movements we're seeing in the loss ratio, with frequency being the big driver coming out of COVID, and then the change in loss adjustment expense. Those two were about 130 basis points of our move. Forty basis points was that we were pricing for inflation, and it's the acceleration that we saw, really, in the back half of June that was that extra 40 basis points, so that is the other part that we picked up. Now, luckily, we were able to take action in the quarter and mitigate about 60 basis points of that move. But that uptick in severity that I talked about, it's not in any specific region. It's across the board.

Elliot Wilbur

Okay, thank you.

Operator

Ladies and gentlemen, that's all the time we have today for questions. We would like to thank you for your participation and interest in today's Trupanion event. You may disconnect your lines or log off the webcast and enjoy the rest of your evening.