MOI GLOBAL

# My Investment Thesis on Trupanion

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In December 2018 we acquired shares of Trupanion (TRUP) at a price of $23.3 per share. TRUP is a founder-led, simple one-product-one-geography business with single-minded focus on a niche service. TRUP has a superior value proposition and strong competitive position afforded by gestation of distributor relationships, a data flywheel and customer switching costs. It operates in a large addressable market with a significant penetration opportunity affording a potentially multi-decade runway for compounding owner earnings. It may come as a surprise that TRUP is also an insurance company.

TRUP provides medical insurance for cats and dogs in the US and Canada. The problem that Trupanion is trying to solve is that it is difficult for pet owners to budget for the magnitude and timing of pet illness and injury. Pet owners do not know the average costs of pet healthcare for the pets that they own. Even if they did, they would not know if their pets will be lucky or unlucky for that breed and location.

Trupanion's solution is a cost-plus insurance product which spreads the risk that the customer's pet is unlucky by subsidising unlucky pets with lucky pet premiums. Like any insurance product Trupanion allows customers to budget for the unpredictable timing and magnitude of loss, in this case pet healthcare costs.

The distribution of TRUP's insurance products is primarily through vet and customer referrals. TRUP uses a network of c. 100 independent contractors called 'Territory Partners' to build long term relationships with vets; they are responsible for making vets aware of the benefits of TRUP's products to the vet's customers, with the goal of earning the trust of the vets.

Like any insurer, TRUP must estimate and hold reserves for vet invoices which have been incurred but not yet submitted, a complex process requiring subjective judgement. Unlike most insurers TRUP is a cash in – cash out business; it does not have a substantial float, nor does the investment income from that float contribute meaningfully to the business's discretionary profits.

Given pet insurance penetration rates in the US of 1%, TRUP's primary competitor is the pet owner who chooses to self-fund pet healthcare costs with cash or debt. TRUP is therefore focused on growing the addressable market vs. taking market share from existing players; the primary challenge in achieving this is the education of pet owners about the merits of TRUP's pet insurance.

The nature of the insurance business model – risk is spread over a large membership for lucky pets to subsidise unlucky pets – is a barrier to profitable entry for small insurance providers. For example, given the fragmented nature of the vet industry, it would not be possible for individual vets to offer their customers insurance products.

TRUP is the largest player in Canada and the second largest in the US, behind Nationwide. Nationwide started in 1982 and was the first pet insurer in the US. It has c. 550k enrolled pets; TRUP has rapidly grown to c. 500k pets and it is likely that TRUP will become the largest player in the US soon.

High retention and net subscriber addition rates are evidence of a strong value proposition. The sources of this superior value proposition stem from (1) a cost advantage that is shared with customers, (2) a data advantage driving more accurate underwriting, and (3) switching costs and symbiotic value chain.

TRUP is vertically integrated; it owns its insurance subsidiary and is responsible for acquiring and servicing existing customers as well as underwriting their insurance. TRUP estimates this vertical integration has eliminated frictional costs of c. 20% of revenues. These economic savings have been donated to consumers in the form of higher claims payout ratios. TRUP's strategy has therefore been to sacrifice the near-term margin upside of this cost advantage in the pursuit of a larger and stickier customer base and subscription revenue pool. This cost advantage does not manifest itself in lower prices, but rather the highest sustainable expenditure on vet invoices per dollar of premiums.

TRUP has built a database over 15 years using 7.5mn pet months of information and > 1mn claims; it has segmented the market into 1.2mn price categories in order to more accurately underwrite insurance costs for a given pet. Of course, determining the point at which the marginal returns on incremental data diminish is difficult, but according to the CEO it would take a competitor 13 years to replicate this data asset. Although Nationwide is larger by number of pets enrolled, its data are likely to be less comprehensive for two reasons: (1) a lack of data for conditions not covered by policies, such as hereditary and congenital diseases, and (2) pricing categories by state rather than zip code, even though the cost of vet care can vary widely within states. TRUP considers its ability to accurately estimate the costs of pet healthcare costs by granular sub- categories crucial to its leading value proposition. This allows for the provision of more relevant products for the customer.

Trupanion Express is software that was developed by TRUP and integrates with vets' practice management systems. Through Trupanion Express, TRUP pays vets directly, within five minutes of a vet invoice being submitted, disrupting the traditional insurance reimbursement model and obviating the need for customers to pay out of pocket and then submit a claim for the expense. This is clearly a superior solution to the reimbursement model in solving customers' cash flow problem associated with unexpected pet healthcare costs. In general, pet owners do not switch insurance providers due to the non-coverage of pre-existing conditions. Trupanion Express is installed in 10% of the 20k hospitals being visited by Territory Partners each year. The integration of this software is likely to improve the loyalty of pet owners and vets.

Finally, TRUP insurance seems to be a win-win-win proposition for pet owners, vets and TRUP:

- Vets' treatment decisions can be dictated by efficacy rather than cost. Pet owners visit the vet more frequently and are more likely to agree to the vet's Plan A treatment recommendation. The goal for Territory Partners is to sign vets up to Trupanion Express, which is free, removes bad debt issues and therefore fosters better relationships with customers. Trupanion Express also eliminates credit card fees, which may constitute c.15% of a vet's profits.
- Pet owners have peace of mind that they will not be hit with unexpected large vet bills and are therefore also less likely to choose economic euthanasia or suboptimal treatment plans. With Trupanion Express they do not need to settle vet invoices out of pocket and then attempt to cover the claim through the traditional reimbursement model.
- Through Trupanion Express TRUP improves the retention of its customer base, freeing up discretionary capital for accelerated pet acquisition.

The addressable market is large and underpenetrated relative to other developed markets. The differences in these other markets are not demographic, social or economic, but rather (1) the length of time comprehensive pet insurance has been available, (2) the value proposition in the form of higher claims payments as a ratio to premiums (higher loss ratios) and (3) vet vs. direct to consumer distribution models. Pet insurance companies in the US typically do not cover hereditary and congenital conditions, which are the forms of illness most likely to be suffered by cats and dogs, they increase rates when claims are made, they impose payout limits, and pay claims according to an estimated cost schedule rather than actual vet invoices. TRUP is different in all these respects and as such expects to grow the addressable market in North America to greater than 1% penetration. In any case, it appears to be the case that TRUP's value proposition is driving adoption in North America.

The unit economics associated with the pursuit of this opportunity to grow the company's assets are attractive. The cost to acquire a pet is c. $150, around 3x the average monthly ARPU. Assuming the current 10% discretionary margin and a six-year average pet life, the IRR on new pets is 30-40%. At a 15% discretionary margin the IRR would be double this. I estimate that both ARPUs and discretionary margins would need to decline by 20-25% to render reinvestment in pet acquisition a capital destructive pursuit. This would contradict the economic reality of a market in which pet healthcare costs are increasing mid-single digits as new technologies and treatments are ported over from human healthcare, and the scalability of the business model.

The CEO owns 7% of TRUP equity/$60mn and in total the executive leadership team owns 10%. This is c 100x the CEO's annual compensation. He automatically sells 2% of his shares each year until he has sold 25% of his interest in the company by 2025. This has been a source of criticism from short sellers but given the large gap between stock ownership and annual remuneration, and the zero-dividend policy, I don't think this represents misalignment with other minority owners of the business.

TRUP's quoted market cap is c. $800mn, c.6x BV and 24x owner earnings of c. $33mn. A 4% owner earnings' yield is reasonable for a business with TRUP's high reinvestment rates and incremental returns on new capital investments if these can be successfully maintained. The strength of TRUP's competitive position and evidence that their value proposition is attractive to pet owners suggest that they can. These owner earnings are one quarter of book value, and the company is growing its assets (enrolled pets) 20-30% each year; 6x BV implies a 6% sustainable growth rate.

Yet incremental returns on reinvested capital are higher than the return on existing net assets, leading to growth rates many multiples of that implied by the market. Finally, management expects scaling of the fixed cost base to drive margin expansion, leading to economic earnings growth higher than revenue growth. By 2020 if management achieves its targets it should be generating c. $450mn of revenues and $65-70mn of discretionary profits. Given the company expects to reinvest all discretionary profits into growing enrolled pets, retained losses are unlikely to improve over that time, leading to a potential RoE of c. 50% in 2020 on an owner earnings basis. At the current price the stock would then be trading at a multiple of its book value that implied zero growth, despite the ample room for enrolled pet expansion afforded by low market penetration and a leading value proposition.

*may go down as well as up and is not guaranteed. Past performance is not necessarily a guide to future performance.*