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Trupanion, Inc.

Second Quarter 2020 Results Call

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CORPORATE PARTICIPANTS

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CONFERENCE CALL PARTICIPANTS

Shweta Khajuria, *RBC Capital Markets*

Maria Ripps, *Canaccord Genuity*

Mark Argento, *Lake Street Capital Markets*

Jonathan Block, *Stifel, Nicolaus & Company*

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PRESENTATION

Operator

Greetings, and welcome to the Trupanion, Inc. Second Quarter 2020 Results Call.

At this time all participants are in a listen-only mode. A brief question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

It is now my pleasure to introduce your host, Laura Bainbridge, Head of Corporate Communications. Thank you. You may begin.

Laura Bainbridge

Good afternoon, and welcome to Trupanion's Second Quarter 2020 Financial Results Conference Call.

Participating on today's call are Darryl Rawlings, Chief Executive Officer, and Tricia Plouf, Chief Financial Officer. Margi Tooth, Trupanion's Chief Revenue Officer, will also 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, 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.

And with that, I will hand the call over to Darryl.

Darryl Rawlings

Thanks, Laura.

It was a strong quarter for Trupanion. Normally, I start with a review of our key financial metrics. This quarter, the metrics speak for themselves, so I'll start with some context around our business performance.

Just a few months ago, we moved our entire workforce remote against the backdrop of a steep and unprecedented economic downturn. Throughout this period of change, the team stepped up in support of our members and delivered on our promise to be there 24/7, 365. In times of uncertainty, the need to help pet owners budget for the unexpected is even greater.

Across the business, we delivered record-breaking service levels, from the speed we answer the phones to how quickly we were able to pay veterinary invoices. These efforts manifested in record monthly retention in the quarter and a record number of pet owners adding pets or referring to friends. Improvement in these metrics paved the way for Nirvana, which we define as a state in which existing member referrals equal or exceed the number of members who cancel. I first coined this term in our 2015 annual shareholder letter. And those of you who follow the story closely know the significance of this metric on our ability to deliver self-sustaining growth in the future.

At our Annual Shareholder Meeting in June, we highlighted Boston as our first U.S. territory to enter a state of Nirvana. Since then, we've made progress in additional U.S. and Canadian territories, bringing our total count of territories in Nirvana to six.

Churn for the trailing 12-month period averaged 1.34% per month. Our highly efficient Refer A Friend and Add A Pet channel comprised 0.75% of pets during the same period. The difference between the two, the gap to Nirvana, was 0.58%, a 16 basis point improvement over the prior-year period. For the stand-alone months of May and June, the gap to Nirvana was only 0.43%. Maintaining service levels will be critical to continuing to drive Nirvana across the business.

At the same time, our field sales team found new and creative ways of interacting with veterinarians and their staff. Relative to the prior period, we believe the total number of touch points actually improved in the quarter. Strategic changes in how we support our field sales team and additional engagement from our account managers strengthened the performance within this core channel. We ended the quarter with over 11,500 active hospitals, a number that has continued to grow in the third quarter.

We saw good success outside the veterinarian in Refer A Friend, Add A Pet channels, as the team was able to dynamically adjust our pet acquisition spend in relation to market opportunities. This is not a new skill for Trupanion. The net result was stronger-than-anticipated performance in our subscription business. While we saw some benefit within our quarterly financial results, the nature of recurring revenue means the impact will be more meaningfully felt in the quarters and years ahead.

With that, I'll review our key financial measures for the quarter.

Total revenue grew 28% year-over-year, and we ended the quarter with over 744,000 total enrolled pets. Adjusted operating income grew 44% year-over-year to $14.1 million, $13.4 million of which was from our subscription business.

Growth in our adjusted operating income sets us up well to deploy capital at attractive internal rates of return. During the quarter, we were able to deploy $8.4 million of our adjusted operating income in pet acquisition spend related to our subscription business at an estimated internal rate of return of 45%, above our 30% to 40% target.

Our internal rate of return benefited from our record-high retention rates in the period, growth in our highly efficient Refer a Friend, Add a Pet channel and expansion in our adjusted operating margin. The combination of margin expansion and improved monthly retention increases the lifetime value of a pet and our allowable acquisition spend as a result, and we intend to be more aggressive in the second half of 2020.

In the quarter, we saw expansion across key metrics - net pet growth, retention, lifetime value of a pet, growth in active hospitals and adjusted operating margin - all while being disciplined with our internal rates of return on invested capital. These results will positively impact the intrinsic value of our Company. For a more detailed discussion of intrinsic value and how our business metrics influence it, please look to my 2019 annual shareholder letter, which we published in April.

In summary, it was a very good quarter for Trupanion. Across nearly every metric, the team hit it out of the park, all while navigating through a period of unprecedented change.

To the team, you came together in support of our members and their pets while raising the bar on our service levels. Well done. And on behalf of all shareholders, we thank you.

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

Tricia Plouf

Thanks, Darryl, and good afternoon, everyone.

We are pleased with our strong financial results for the second quarter, which exceeded our expectations. Our overperformance was led by record monthly retention and solid growth additions in our subscription business and continued growth in our other business. Before getting into the results, I'll provide high-level context for how our performance compared to our expectations.

In late April, when we last provided guidance, our lead volume from veterinarians was down as much as 20% compared to the prior year. We've since seen wellness visits at the veterinarian rebound. Also in April, retention was consistent with historical levels after a slight decline at the end of Q1. We also have seen a slight reduction in the number of veterinary invoices, though it remains unclear how quickly volumes would begin to increase. In light of market uncertainties, we had pulled back our pet acquisition spending early in the second quarter, particularly our test spend.

With that as a backdrop, I'll review our second quarter performance in more detail.

Total revenue for the quarter was $117.9 million, up 28% year-over-year.

Subscription revenue was $92.5 million in the quarter, up 19% year-over-year or 20% on a constant currency basis. Total enrolled subscription pets increased 15% year-over-year to over 529,000 pets as of June 30.

Average monthly retention, which is calculated on a trailing 12-month basis, was 98.66% compared to 98.57% in the prior-year period. We note that approximately 1,600 failed payment cancellations were deferred from Q2 into Q3 as a result of a change in process due to COVID. Adjusting for these cancellations, our retention rate would still be excellent at 98.64%.

For additional context, retention for Q2 on a stand-alone basis and adjusted for those failed payments was 98.78%, our highest quarter on record. As a reminder, nearly 96% of our subscription revenue for a given quarter is from our existing book of business, demonstrating the impact of strong retention rates on our business model.

Monthly average revenue per pet for the quarter was $59.40, an increase of 4% year-over-year or 5% on a constant currency basis. In local currency, U.S. ARPU increased 5% and Canadian ARPU increased 3% over the prior-year period.

Our other business revenue, which is comprised of revenue from our other product offerings that generally have a B2B component, totaled $25.5 million for the quarter, an increase of 76% year-over-year. Year-over-year growth in our other business segment reflects an increase in the number of pets enrolled.

Subscription gross margin was 20% of revenue in the quarter, compared to 18% in the prior-year period and within our annual target of 18% to 21%. Our subscription gross margin was comprised of 71.2% paying veterinary invoices and 9.2% variable expenses as a percentage of subscription revenue.

During the quarter, we saw a reduction in veterinary invoice volume that increased our subscription gross margin by about 1% of revenue. Early in Q3, we have seen veterinary invoice volumes trending back in line with pre-COVID levels.

Total gross margin was 17%, which includes our lower-margin other business segments.

Total fixed expenses in the quarter scaled to 5.2% of total revenue, down from 5.6% in the prior-year period. I also want to note that during the quarter, we were able to resolve the majority of our known regulatory matters, including a recent matter with New York in the amount of $90,000.

We generated $14.1 million of total adjusted operating income during the quarter, an increase of 44% over the prior-year period.

Net income in the quarter was $1.4 million.

Adjusted operating income from our subscription business segment during the quarter was $13.4 million or 14.5% of subscription revenue. This margin expanded 250 basis points over the prior-year period, benefiting from a reduction in veterinary invoice expense and scale in fixed expenses.

As a reminder, our target margin profile for our subscription business is to generate 15% adjusted operating margin before new pet acquisition spend. We continue to close the gap on fixed expenses, nearing our targeted scale of 5% of revenue. We also continue to make progress on initiatives aimed at pricing as accurately as possible to our 71% value proposition, but we do expect to be closer to 72% for the full year of 2020.

During the quarter, we deployed $8.4 million of our adjusted operating income to acquire over 38,000 new subscription pets, resulting in a PAC of $199 in the quarter, an estimated 45% internal rate of return on a single average pet. This compared to $8.2 million in the prior year to acquire approximately 35,000 new subscription pets, resulting in a PAC of $213, an estimated 42% internal rate of return on a single average pet.

I'll take a moment to reiterate that we are continuously evaluating our PAC spend, ensuring we operate within our internal rate of return guardrails, and to reflect current market opportunities. At 45% estimated internal rates of return, we left some opportunity to be more aggressive.

Free cash flow was $3.1 million during the quarter, and operating cash flow in the quarter was $4.9 million compared to $2.9 million in the prior-year period.

Adjusted EBITDA was $5.5 million in the quarter, up from $1.3 million in the prior-year period.

Net income was $1.4 million or $0.04 per basic and diluted share compared to a net loss of $1.9 million or $0.06 loss per basic and diluted share in the prior-year period.

These results demonstrate that we have the levers to control our bottom line profitability and cash flow while continuing to grow during uncertain times.

Trupanion's balance sheet remains strong, with over $105 million of cash and investments and ample availability on our existing line of credit. At June 30, we had approximately $27.3 million of long-term debt.

I'll now turn to our outlook for the third quarter and an update for the full year of 2020. I'll once again highlight that while we are not immune to economic challenges, the recurring nature of our business model provides us with a higher degree of visibility into our future performance than most. Quarter-to-date, we've seen a continued improvement in lead volume, and strong conversion and retention rates. That said, we're monitoring the pace of the market recovery and what impacts the virus may continue to have, if any, on activity at North American veterinary hospitals. With that as a backdrop, we are updating our full year guidance to reflect our overperformance in the quarter, while maintaining a slightly wider range to account for some market uncertainty.

We now expect revenue for the full year to be in the range of $487 million to $491 million, or 27% year-over-year growth at the midpoint. For the third quarter, we are expecting total revenue in the range of $126 million to $127 million, representing 27% growth at the midpoint.

Our full year subscription revenue is now expected to be in the range of $382 million to $386 million, 20% growth at the midpoint. For the third quarter, we are expecting subscription revenue in the range of $98 million to $99 million, representing 19% growth at the midpoint.

Our other business segment, which continues to perform well but has less visibility, is now expected to be around $105 million for the year.

At these updated revenue levels, we expect total adjusted operating income for the year to be around $56 million, with approximately $53 million coming from our subscription business.

Our total pet acquisition spend will flex up or down as needed in response to market opportunities. With this in mind, we estimate our allowable acquisition spend per pet within our 30% to 40% internal rate of return guardrails will be between $240 and $270 for the full year. At the midpoint, this would equate to total pet acquisition spend for the year of around $43 million.

Also, please keep in mind that our revenue projections are subject to conversion rate fluctuations between the U.S. and Canadian currencies. For our guidance, we used a 73% conversion rate in our projections, which was the approximate rate at the end of June.

In summary, we're very pleased with our Q2 financial performance and our ability to navigate through the current market landscape. Our financial position is strong, and we will continue to be disciplined in the allocation of our capital.

Thank you for your time today, and I will now turn the call back over to Darryl.

Darryl Rawlings

Thanks, Trish.

We'll open it up for Q&A momentarily. Joining us for today's Q&A session is Margi Tooth, our Chief Revenue Officer, who can help provide some additional context on our performance in the quarter.

I also want to point your attention to a few upcoming investor events. Both Tricia and I will be participating in the upcoming virtual Canaccord conference next week. We'll also be hosting a series of virtual non-deal roadshows over the course of August and September. We hope to speak to many of you then.

With that, Tricia, Margi and myself are now available for your questions.

Operator

Thank you. We will now be conducting a question-and-answer session. If you would like to ask a question please press star, one on your telephone keypad. A confirmation tone will indicate your line is in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment it may be necessary to pick up your handset before pressing the star keys. One moment please while we poll for your questions.

Our first question comes from the line of Shweta Khajuria with RBC Capital Markets. Please proceed with your question.

Shweta Khajuria

Okay. Thank you. Two questions, please.

First, on retention rates. What gives you confidence? I mean, at the shareholder event, you had pointed out the growth in retention in May. And it would be great to hear your thoughts on what gives you most confidence in the sustainability of this retention rate.

And the second question is, what—any trends in particular that you can call out from July?

Darryl Rawlings

Thanks, Shweta.

Well, you're right that we first started to see an increase in our retention rate since we spoke about it at our shareholder meeting in June. The main areas that gives us confidence that—at least we have a road map we'll still have to execute. In the beginning of Q2, knowing that there was a lot of uncertainty with COVID and looking at the end of March, we went back to the team and said, “This is a time to really focus on our existing members. We don't know what the opportunity is going to be like outside of our control, but let's really focus on taking care of the customer.” And we did that by paying our invoices faster than ever, answering the phones quicker. And the team really rallied, and I can't say enough about what the team did. What we saw on the backside of that was record level NPS scores, record level retention; and pretty much across the board on every way that we measure it, we saw improvements in our retention rates in April and May and June, and we have seen also improvements in July to date.

We think we have the formula. It's not overly complicated. When you partner with veterinarian hospitals, when you have the ability to pay hospitals directly in seconds or minutes, and when you're able to answer the phones and service the client even faster and better than we've done historically, we think not only are our retention rates going to be able to be sustained at higher levels than historical averages, but we'll see higher referral in Add a Pet because happy clients mean they're telling their friends and adding pets. So, confidence that we have the road map, and it's up to the team to execute. I'm sure over the next few years to come, there'll be bumps along the way, but we're feeling pretty positive.

And then you asked about any trends in July, and as I mentioned just previously, we've seen the retention trends continue. We're seeing really strong results everywhere in July. And the veterinarians are really running off their feet right now. We're seeing a lot of wellness visits. There are some challenges for us at curbside check-in to learn how to best access that. So I think there's some opportunities to learn, but July has trended similar to Q2.

Shweta Khajuria

Okay. Thank you, Darryl

Operator

Thank you. Your next question comes from the line of Maria Ripps with Canaccord Genuity. Please proceed with your question.

Maria Ripps

Thanks for taking my questions and congrats on strong results.

Any more color maybe you could share with us on higher gross additions in the quarter in light of lower PAC? And any particular channels maybe that were very productive for you this quarter? I know you highlighted higher referrals. But is there anything else that you highlight?

And Darryl, I think you mentioned being a little bit more aggressive in the second half with spending. Can you maybe give us a little bit more color on that?

Darryl Rawlings

Sure. I think I'll hand this over to Margi, who can answer the question better than I can.

Margaret Tooth

Yes. Thanks, Darryl.

Hi, Maria. I would say that in terms of gross additions, the vet channel continued to outperform other channels that we operate within. And in doing so, allowed us to have the really efficient lower PAC there. It's always very productive for us and it's always something that we work hard to maintain efficiencies. We made some adjustments partway through the quarter, having spent a number of quarters and years looking at what's the right thing to do in terms of continuing to get growth and efficiency. And those changes certainly led to a more effective lead generation and conversion across the board, which is very positive for us moving forward.

And so not only do we have new tools, new messaging adoptions there. We've also looked at the Refer a Friend and Add a Pet channels. To Darryl's earlier point, when you look at the improvements we made across the business, those channels significantly help not only within our new pets coming into the market, so you have a great experience, you answer the phone quickly, invoices get paid very quickly, the software massively helps there; we've also seen the breeder channel continue to perform strongly for us. It's a channel that's not as large as the vet channel, but it's a great channel. The team have worked very hard and pushing forward. And it's really across the board. If you look across all of the channels we operate it, positively, they've been performing well.

In terms of getting more aggressive with PAC in the second half of the year, we always look at trying to carve our PAC spend into three different areas, the core channels, which is the vet channel, predominantly for us. And then looking at where are the areas that we're less confident in what they can deliver. So we'll be doing more in the lines of—maybe it's a little bit more direct-to-consumer and focusing on the conversion side of things. It could be anything from outdoor to more online activity, just being more aggressive testing, in the hope that we can take the learnings from Q2, Q3 and 4, to put into more of our core spend, ultimately, which is how we continue to grow, right, from a PAC perspective and also from a pet count point of view.

Darryl Rawlings

And the one thing I'd like to kind of add is the record retention rates that we've seen in Q2, even based on a 12-month average, so not getting full credit of what we accomplished in Q2, it increases the lifetime value of a pet. It increases from an average 71 months to 75 months. That means the stream of cash flow that we're going to have is larger, which means to have the same internal rates of return, we can spend more money, we can be more aggressive in the marketplace. So it's the fact of our expanding adjusted operating margin and the big improvements we've made on retention which will allow us to have capital to be more aggressive, and Margi and her team will figure out how to best utilize that money.

Maria Ripps

That's very helpful. And maybe another question, if I could. Can you maybe talk about how your territory partners and inside account managers' roles and responsibilities may have changed since the start of the pandemic? And whether there are any changes to how you view your sort of sales structure post COVID that could potentially result in cost savings going forward?

Darryl Rawlings

Yes. I'll hand this to Margi.

I will say that what we've done in the field pre COVID, we even started to make some changes. If you look over the last couple of years, there's a few areas that we weren't growing as quickly as we wanted or getting the results we wanted. So we made some changes with the teams. As I mentioned in my opening remarks, it led to more touch points at the vet hospital. Now we're having to learn how to do that differently on curbside versus regular check-in. But we've got new teams of people working on the tools and the tactics, and we're super encouraged by the results we've seen.

I don't know if I stole your thunder there, Margi, if you have anything else to add.

Margaret Tooth

A little bit. I think to that point, one of the things that we've really—has helped us to get a lot better relationship between the territory partners and account managers, which we're already operating really, really well together. And the touch points, they lend very different skills to the hospitals. But I think them still having that outreach, they have the relationship. So if you imagine, the vets are in the process of going through COVID. And it's challenging for the wellness business to pick up. They need all the support they can get. So the TP role changes more of a supporting function than probably would otherwise have been, which is good and effective.

One of the biggest things that we took out of the back end of Q2—Q1, sorry, going into Q2, was we wanted to make sure that we're in a position to leverage the data that we have and the expertise that we have in the industry and to work with the partnerships we have across the board in the animal health industry, not just in North America but globally, to do what we could to do our part to support pet owners in crisis, COVID mode.

Our Chief Veterinary Officer, Dr. Steve Weinrauch, set up the COVID Council and spearheaded that initiative, which led to a massive social media outreach that not only hit new pet owners and helped to raise brand awareness of Trupanion, but it also reinforced to our hospitals that we're working with, how we can help them. We can help them understand how do you message COVID, how do you message safe practices with pets. And as they're looking at this curbside pickup, which is a very different way of operating for them, the industry is really reaching out and looking for people that can help them practically in moments of need like that.

So that's really where we've seen a big efficiency, both from a territory part and in account management mode. And we—to Darryl's point, we continue to look at ways that we can better leverage curbside using our coaching messaging to improve beyond that.

Maria Ripps

Got it. Thank you very much.

Operator

Thank you. Our next question comes from the line of Mark Argento with Lake Street Capital Markets. Please proceed with your question.

Mark Argento

Good afternoon.

Just wanted to get your impression on—obviously, with the pandemic, it seems like new pets are up overall. People are getting more puppies and kittens and all that stuff. What do you think—are you guys able to kind of quantify that at all and the impact from that? Is that what you're benefiting from right now? Or do you think there's a multiple quarter and a positive effect from that?

And then just one quick follow-up on looking at any direct-to-consumer channels that you guys have continued to try here in the environment?

Darryl Rawlings

Well, Mark, we've heard a lot about the increase in new pet ownership. And I'm going to do a little science for people here. There's no doubt that the demand for pets has been increasing. We've seen this in other recessions. When people have a lot of uncertainty, when people are at home more, people lose their jobs, often, people are saying this is a good time to bring a pet home to train them. You layer that on top of with COVID, with quarantining, and people are saying this is a great time to get a new pet.

Now there's no doubt that in March and April, the shelters got cleared out. It was great. Humanity came to the rescue of our four-legged friends and made sure that they were taken care of. But there is a supply issue. And everybody has talked about this wave of new pet ownership. And I think people are following stories in social media more than math. No doubt that demand is up. But in March and April, a breeder was not able to produce more pets. It takes, on average, about four to five months to increase the supply of pets from the time a pet is conceived until it goes home.

We've really started to see just in the month of July and hearing reports from veterinarians that they're seeing a lot of new pets in the month of July. We didn't see a lot of it in Q2. No doubt there is a lot of demand. I would expect that we're going to see more of it in the back half of this year, and we'll see how we fare in those areas. And I'll hand over the D2C channels.

Margi, is there anything that you're seeing that was exciting in Q2 or in Q3?

Margaret Tooth

It's an interesting quarter for us in D2C. As a reminder, we think of anything that's direct-to-consumer as a conversion part of our strategy, so the vet channel is core to the lead generation, really helps us to grow the business and is independent of what we're seeing and continues to be. But from a direct-to-consumer side of things, we were very quiet in April, again, as a result of coming out of the early signs of COVID. As we start to get more aggressive with our spend, we did do a little bit more testing. We were able to take advantage of some of the media, which was a little bit cheaper than it may otherwise have been and drove some good results. Our PAC is representative of that.

I think we continue to learn and test and continue to try all sorts of different direct-to-consumer channels. Nothing right now is kind of blowing us out of the water, but it helps to just drive that conversion a little bit quicker, and in support of the vet channel.

Mark Argento

Great. Thank you.

Darryl Rawlings

Thanks, Mark.

Operator

Thank you. Our next question comes from the line of Jon Block with Stifel. Please proceed with your question.

Jonathan Block

Thanks, guys. Good afternoon. A couple of pretty quick questions.

Trish, the first one for you is just looking at the balance sheet, the AR, I think it's up maybe 85% or 90% year-over-year. Some of that might be a function of the other division, which I think it's somewhat tied to. But it even seems to be outstripping the impressive growth in the other divisions. So can you just talk about the AR being up 85% to 90% year-over-year? And I think that's sort of a trend line that may have accelerated over the past couple of quarters.

Tricia Plouf

Yes, Jon. You're right that the majority of our accounts receivable balance is related to our other business segment. Very small amount of AR, which kind of grows in line with subscription revenue growth. It's related to subscription business, it’s related to kind of month-end deposits in transit that haven't settled yet.

A good portion of our other business segment - unlike the Trupanion product, which is monthly and renews monthly - the majority of the other business segment is an annual product. And the accounting for an annual product is to record the receivable upfront if you allow collection on a monthly basis. So it trends relatively in line with overall revenue growth in that segment. If you look down in the liabilities, they're nearly an equal and offsetting deferred revenue amount. So it's effectively kind of a balance sheet gross up that occurs related to accounting for an annual product with monthly payments because you're recording the revenue and then deferring nearly all of it until it's recognized over the course of the year, and then recording a receivable, and then that receivable comes down as the payments are made monthly by the customers. So it's just a function of the type of product, being monthly and quarterly, and being really a balance sheet accounting gross up.

Jonathan Block

Okay. Got it. Very helpful. Maybe I can follow-up a little bit with you offline there.

The other one, Darryl, I think it's for you, and it's just sort of a big picture question. I mean, a lot clearly went right in the quarter, but to the same extent though, something seems somewhat temporary. And that's where I'd love some color from you. In other words, PAC was $199, very low, but you talked about it still being $240 to $270 of the year, which implies a big pickup in 2H. The pricing, the subscription gross margin was really good in the quarter but I think, Trish, you even talked about it moving maybe even outside the guardrails.

So Darryl, just sort of an all-encompassing question: can you talk about what was really good in the quarter that you view as sustainable going forward in coming quarters or years versus what might have been advantageous for the three-month period that might somewhat unwind over the next six to 12 months? Thanks.

Darryl Rawlings

Well, Jon, what you're talking about is the leverage that we have in this business. We don't have to spend our PAC dollars to grow year-over-year. And if you read the shareholders or I know a lot of our shareholders read the letters and talk about the impact of Nirvana, it talks about what type of money can hit our bottom line while having kind of normalized growth rates.

The levers that we have for our pet acquisition spend are driven by the amount of cash flow that's generated and how much we want to be able to spend during the time. Now in that spend, we have a combination of the things that we're doing regularly, which are efficient and repeatable, and we often have a group of test spending. What we demonstrated in this quarter is we don't have to spend that money. We actually pulled a lot of it back, and that lowered the PAC spend for a period of time. It should show investors the ability, the levers that we have to control our business and our destiny.

Now as I mentioned before, when we look at invested capital, we're talking about the internal rate of return on invested capital. And one of the things that really came out, which should be sustainable quarter after quarter if we can continue to execute, is taking our retention rate from 70 months historically and starting to push it up to closer to 75 and maybe, potentially, even higher in the years to come if the team can really rally. When that happens, the stream of cash flow over the pet's life will go up. And our allowable PAC spend, the amount that we can spend to acquire a pet while still maintaining very, very high internal rates of return, will go up.

Earlier, Trish mentioned to be getting, on average, a 35% internal rate of return. We can be spending, I think our guardrails were $240 and $270 to acquire a pet; that gives us the ability and the flexibility to kind of lead the category and to learn and grow, invest in areas that will take us five and 10 years. I think that's the biggest kind of standout when I look at your question, is what was really one-time. March and April, which straddled Q1 and Q2, were kind of the biggest change where we saw that traffic down and just a lot of impact in the marketplace, but going from May, June and July, we've seen consistency and feel really comfortable moving forward.

Jonathan Block

Thanks for the color, guys.

Operator

Thank you. Once again if you would like to ask a question please press star, one on your telephone keypad. For participants using speaker equipment it may be necessary to pick up your handset before pressing the stars keys.

Our next question comes from the line of David Westenberg with Guggenheim Securities. Please proceed with your question.

David Westenberg

Hi. Thank you for taking the question.

I want to continue a little bit with Mark's question in terms of piecing out—I get the biology argument, but I am trying to kind of figure out what COVID might have done in the quarter that might be different. So can you talk about if you know whether or not, like through industry data, whether or not you're gaining or losing market share? Or how you're doing relative to competitors, maybe in the quarter?

And then as a continuation of that, are you seeing any differences in the marketing strategy of these competitors? Again, I'm just trying to figure out how much of a COVID bump there is to help kind of—help normalize the long term, what the business looks like?

Darryl Rawlings

Well, with the best information that we have, if you look at 2018 and '19, even going back to 2017, we've been leading the category's revenue growth year-over-year, based on the information that we have. We would expect that that will continue for 2020, and we expect that similar things will happen in Q2 versus other areas.

The one place that we're seeing the benefit is because of our relationship with veterinarians, because we're paying pet owners directly, because we're paying so quickly, those are things that are not easy for competitors to replicate. And that's where we're seeing our net pet growth accelerate, because with lower churn, it gives us the ability to accelerate the net pet growth, and you have to have the net pet times the monthly cost to give you your revenue. I would expect that maybe we're accelerating in that, were compared to the overall market, because I think we lead in retention. I'm confident we lead in retention. But outside of that, I think the demand for pets, the demand to help people budget and care for their pets goes up in recessions and downturns, and I think it will help the overall category as well as Trupanion.

David Westenberg

I appreciate that. And I realize that the need for insurance during recession is higher and you've historically shown very strong growth in a recession. But I am curious if maybe this kind of situation is different because we're having maybe unemployment be a precursor to a recession as opposed to a normal recession. And with that—with setting it up like that, I'm just curious if you anticipate any impacts from this high unemployment rate. Maybe you need to extend terms. Maybe—should we see any impacts on needing to extend terms to consumer customers and maybe future impacts on receivables from that? Again, I appreciate that your business is fairly recession-resistant. I'm just kind of curious if this time, it's different, the proverbial, this time it's different?

Darryl Rawlings

Yes. Well, we're not going to be extending terms to our members like car insurance companies. The reason that they were able to—in a different situation than us is people stop driving, which means the likelihood of getting in a car accident are lower. Well, guess what? The likelihood of a pet getting sick or injured are not lowered in a world of COVID than in a world without COVID. And in fact, many could say that with more pets at home and more people at home to notice issues, we could actually see an uptick in the level of frequency. And veterinarians are certainly seeing that in the month of July - they're running off of their feet.

I don't think there's anything particularly unique so far. March and April was the shock-and-awe and low volume, and then after that time, it's acted like other recessions. I will tell you, through other recessions our retention rates have always held. We have not seen, historically, retentions raised the way that they have. I mean we're at 20-year highs in this Company, quarterly and monthly, on retention rates. And we put that directly to the efforts that the team has put together to servicing our clients, and certainly our software and paying with automation have all helped.

David Westenberg

Thank you.

Operator

Thank you. Our next question comes from the line of Greg Gibas with Northland Securities. Please proceed with your question.

Greg Gibas

Thanks for taking the questions. Congrats on the quarter.

First of all, just to quickly revisit the vet leads, can you provide just a little bit more color on how those, I guess, lead volumes on vet channels trended throughout the quarter? I know it was back in April, you mentioned them being down about 20%, but maybe how did those improve in Q2 on a monthly basis? And then how has that maybe trended into July, just relative to that down 20% level at the beginning of Q2?

Darryl Rawlings

Yes. Leads in Q2 were up about 8% year-over-year of vet leads the way that we track it. So we typically would expect the leads to be up 10% to 20% by channel year-over-year to hit our growth rate. So they were a little bit down at 8%, but definitely trending up as we saw the quarter go on.

Greg Gibas

Got it. That's super helpful, Darryl. And then the second one for me would just be regarding that newly implemented or, I guess, recently implemented retention team that you kind of directed at improving the so-called save rates: how much of an improvement, I guess, have you seen since forming that team? And where, I guess, are you seeing those save rates level out? Or are they continuing to improve since implementing that team?

Darryl Rawlings

Well, I'll hand it over to Margi, and I'm not sure how much secret sauce she'll give you. But the team has performed really well.

Margaret Tooth

Greg, I'm not going to give you too much secret sauce. But I will say that in terms of save rates, this definitely helped us. We've taken a team of—they're very dedicated and skilled at having conversations. One of the things that—it's not just about the team and the people taking the call and having the conversation, it's also around how quickly you respond to that person. So whether or not someone is calling because they don't understand why their invoice wasn't paid, they want to check up on something, you haven't got the volume of people going to a level where they need to be antagonized enough to call us because we're communicating with them quickly. The software helps us to do that. The hospitals help us to do that.

It's definitely part of the puzzle, but there are a number of different elements here that make us confident that it's not just about the COVID impact. There are some operational changes. There's some shifting in messaging. There's added value proposition in coaching, both in the field but also from our internal teams and having that confidence at the hospital level that we're able to deal with their clients quicker than they could deal with them if they're paying with a credit card. So the retention team is part of it. And across the board, if you look at all the retention buckets, we've seen increases, which is positive and tells us that this isn't just a COVID-related effort.

Hopefully, that answers your question.

Greg Gibas

That does. Okay. That's very helpful. Last quick one for me was just if you can share anything regarding that partnership with Rayne, maybe when we would see those products hit the market. And if anything has really been discussed regarding that—the strategy with marketing that product line?

Darryl Rawlings

Yes. So the question you're asking is about a pet food initiative that we've made some investments in. Our hypothesis is that pets that eat high-quality food over their life will have better health outcomes. And we've made some investments to figure out how to test that. We're looking at, in the next several months and quarters, doing some more testing to figure out how we can learn about that hypothesis, but it is going to be a very long-term project.

Greg Gibas

Okay. Thank you.

Operator

Thank you. We have reached the end of our question-and-answer session and the conclusion of today's call. Thank you for your participation. You may now disconnect your lines, and have a wonderful day.