

TRUPANION INC.
Form 10-Q
August 02, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2017

or

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

For the transition period from _____ to _____

Commission File Number: 001-36537

TRUPANION, INC.

(Exact name of registrant as specified in its charter)

Delaware

83-0480694

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification Number)

6100 4th Avenue S, Suite 200

Seattle, Washington 98108

(855) 727 - 9079

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). ☒ Yes ☐ No

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

Large accelerated filer ☐

Accelerated filer

☒

Non-accelerated filer ☐ (Do not check if smaller reporting company)

Smaller reporting company ☐

Emerging growth company ☒

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

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

As of July 27, 2017, there were approximately 29,995,543 shares of the registrant's common stock outstanding.

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Note About Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. All statements contained in this Quarterly Report on Form 10-Q other than statements of historical fact, including statements regarding our future results of operations and financial position, our business strategy and plans and our objectives for future operations, are forward-looking statements. The words “believe,” “may,” “will,” “potentially,” “estimate,” “target,” “continue,” “anticipate,” “intend,” “could,” “would,” “project,” “plan” and “expect,” expressions that convey uncertainty of future events or outcomes, are intended to identify forward-looking statements. These forward-looking statements are subject to a number of risks, uncertainties and assumptions, including those described in Part II. Item 1A. “Risk Factors” and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in a very competitive and rapidly changing environment, and new risks emerge from time to time. It is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. In light of these risks, uncertainties and assumptions, the forward-looking events and circumstances discussed in this Quarterly Report on Form 10-Q may not occur and actual results could differ materially and adversely from those anticipated or implied in the forward-looking statements. You should not rely on forward-looking statements as predictions of future events. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee that the future results, levels of activity, performance or events and circumstances reflected in the forward-looking statements will be achieved or occur. We undertake no obligation to update publicly any forward-looking statements for any reason, except as required by law.

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

Investors and others should note that we announce material financial information to our investors using our investor relations website (<http://investors.trupanion.com>), Securities and Exchange Commission filings, press releases, public conference calls and webcasts. We use these channels, as well as social media, to communicate with our members and the public about our company, our services and other issues. It is possible that the information we post on social media could be deemed to be material information. Therefore, we encourage investors, the media, and others interested in our company to review the information we post on the United States social media channels listed on our investor relations website.

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Trupanion, Inc.

Consolidated Statements of Operations

(in thousands, except per share data)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue	\$58,275	\$ 45,832	\$113,004	\$ 88,531
Cost of revenue:				
Claims expenses	41,009	32,466	80,196	63,070
Other cost of revenue	6,915	5,100	13,302	9,891
Gross profit	10,351	8,266	19,506	15,570
Operating expenses:				
Sales and marketing	4,372	3,564	8,461	7,404
Technology and development	2,322	2,164	4,725	4,451
General and administrative	4,245	3,495	8,257	7,217
Total operating expenses	10,939	9,223	21,443	19,072
Operating loss	(588)	(957)	(1,937)	(3,502)
Interest expense	109	41	246	71
Other (income) expense, net	(1,112)	(38)	(1,140)	(55)
Income (loss) before income taxes	415	(960)	(1,043)	(3,518)
Income tax expense	4	4	28	18
Net income (loss)	\$411	\$ (964)	\$ (1,071)	\$ (3,536)
Net income (loss) per share:				
Basic and diluted	\$0.01	\$ (0.03)	\$ (0.04)	\$ (0.13)
Weighted-average common shares outstanding:				
Basic	29,510,907	28,348,348	29,383,502	28,173,798
Diluted	32,734,624	28,348,348	29,383,502	28,173,798

Trupanion, Inc.

Consolidated Statements of Comprehensive Income (Loss)

(in thousands)

(unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income (loss)	\$411	\$(964)	\$(1,071)	\$(3,536)
Other comprehensive income:				
Change in foreign currency translation adjustments	111	11	123	300
Change in net gains on available-for-sale debt securities	16	6	9	8
Other comprehensive income, net of taxes	127	17	132	308
Comprehensive income (loss)	\$538	\$(947)	\$(939)	\$(3,228)

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

	June 30, 2017 (unaudited)	December 31, 2016
Assets		
Current assets:		
Cash and cash equivalents	\$ 24,604	\$ 23,637
Short-term investments	32,565	29,570
Accounts and other receivables	17,098	10,118
Prepaid expenses and other assets	2,294	2,062
Total current assets	76,561	65,387
Restricted cash	600	600
Long-term investments, at fair value	2,829	2,579
Equity method investment	—	271
Property and equipment, net	7,988	8,464
Intangible assets, net	4,950	4,910
Other long-term assets	2,723	134
Total assets	\$ 95,651	\$ 82,345
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 1,779	\$ 2,006
Accrued liabilities and other current liabilities	6,582	5,416
Claims reserve	10,820	9,521
Deferred revenue	20,442	13,463
Total current liabilities	39,623	30,406
Long-term debt	6,309	4,767
Deferred tax liabilities	1,623	1,623
Other liabilities	944	834
Total liabilities	48,499	37,630
Stockholders' equity:		
Common stock: \$0.00001 par value per share, 100,000,000 shares authorized at June 30, 2017 and December 31, 2016, 30,652,240 and 29,994,940 shares issued and outstanding at June 30, 2017; 30,156,247 and 29,498,947 shares issued and outstanding at December 31, 2016	—	—
Preferred stock: \$0.00001 par value per share, 10,000,000 shares authorized at June 30, 2017 and December 31, 2016, and 0 shares issued and outstanding at June 30, 2017 and December 31, 2016	—	—
Additional paid-in capital	132,950	129,574
Accumulated other comprehensive loss	(245)	(377)
Accumulated deficit	(82,352)	(81,281)
Treasury stock, at cost: 657,300 shares at June 30, 2017 and December 31, 2016	(3,201)	(3,201)
Total stockholders' equity	47,152	44,715
Total liabilities and stockholders' equity	\$ 95,651	\$ 82,345

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

	Six Months Ended June 30,	
	2017	2016
Operating activities		
Net loss	\$(1,071)	\$(3,536)
Adjustments to reconcile net loss to cash provided by operating activities:		
Depreciation and amortization	2,113	1,524
Stock-based compensation expense	1,669	1,439
Gain on sale of equity method investment	(1,036)	—
Other, net	56	39
Changes in operating assets and liabilities:		
Accounts and other receivables	(6,968)	(994)
Prepaid expenses and other assets	(183)	463
Accounts payable, accrued liabilities, and other liabilities	913	(1,203)
Claims reserve	1,259	1,244
Deferred revenue	6,929	1,284
Net cash provided by operating activities	3,681	260
Investing activities		
Purchases of investment securities	(14,895)	(11,223)
Maturities of investment securities	11,712	9,338
Proceeds from sale of equity method investment	1,402	—
Purchases of property and equipment	(1,264)	(1,090)
Other investments	(2,753)	(69)
Net cash used in investing activities	(5,798)	(3,044)
Financing activities		
Proceeds from exercise of stock options	1,647	1,785
Proceeds from debt financing, net of financing fees	1,459	986
Payments on capital lease obligation	(203)	(73)
Net cash provided by financing activities	2,903	2,698
Effect of foreign exchange rate changes on cash, cash equivalents, and restricted cash, net	181	337
Net increase in cash, cash equivalents, and restricted cash	967	251
Cash, cash equivalents, and restricted cash at beginning of period	24,237	17,956
Cash, cash equivalents, and restricted cash at end of period	\$25,204	\$18,207
Supplemental disclosures		
Noncash investing and financing activities:		
Purchases of property and equipment included in accounts payable and accrued liabilities	352	75
Property and equipment acquired under capital lease	66	326

Trupanion, Inc.

Notes to the Consolidated Financial Statements (unaudited)

1. Nature of Operations and Significant Accounting Policies

Description of Business and Basis of Presentation

Trupanion, Inc. (collectively with its wholly-owned subsidiaries, the Company) provides medical insurance for cats and dogs throughout the United States, Canada and Puerto Rico.

The financial data as of December 31, 2016 was derived from the Company's audited consolidated financial statements. The accompanying unaudited interim consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) and, in management's opinion, have been prepared on the same basis as the audited financial statements and include all adjustments, consisting of normal recurring adjustments, necessary for the fair presentation of the Company's financial position, results of operations, comprehensive income (loss), and cash flows for the interim periods. These unaudited interim consolidated financial statements should be read in conjunction with the Company's audited financial statements included in the Company's Annual Report on Form 10-K, filed with the U.S. Securities and Exchange Commission on February 15, 2017 (the 2016 10-K). The Company's accounting policies are described in Note 1 to the financial statements included in the 2016 10-K. Operating results for the three and six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the full fiscal year or any other interim period.

Reclassifications

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

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from such estimates. See Note 1 to the audited financial statements included in the 2016 10-K for additional discussion of these estimates and assumptions.

Accumulated Other Comprehensive Loss

There were no reclassifications out of accumulated other comprehensive loss during the three and six months ended June 30, 2017 and 2016.

Accounting Pronouncements Adopted During Period

In November 2015, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) amending the accounting for income taxes and requiring all deferred tax assets and liabilities be classified as non-current in the consolidated balance sheets. The Company adopted this ASU as of January 1, 2017 and has retrospectively applied the provisions of this standard.

In March 2016, the FASB issued an ASU amending the accounting for employee share-based payments, including income tax recognition and classification. The Company adopted this ASU as of January 1, 2017. As a result, the Company has elected to use actual forfeitures in the estimate of stock-based compensation expense. Additionally, the guidance related to the accounting for excess tax benefits and deficiencies resulted in an initial adjustment as of January 1, 2017 to the Company's net operating loss deferred tax asset to eliminate the Company's existing windfall pool amounting to \$4.3 million, which was offset by an adjustment to the Company's valuation allowance. Finally, tax withholding of shares will be allowed up to the employee's maximum individual tax rate in the relevant jurisdiction without resulting in liability classification of the award, subject to the Company's internal policies for making this election.

Recent Accounting Pronouncements

In February 2016, the FASB issued an ASU amending the lease presentation guidance. The ASU requires organizations that lease assets to recognize the rights and obligations created by those leases on the consolidated balance sheets. This ASU is effective for fiscal years beginning after December 15, 2018 including interim periods within that reporting period, with early adoption permitted. The Company plans to adopt this guidance as of January 1, 2019. The Company has determined this guidance will require recognition of a lease liability and corresponding asset

on the consolidated balance sheets equal to the present value of minimum lease payments. The carrying amount of the asset is derived from the amount of the lease liability at the end of each reporting period.

2. Net Income (Loss) per Share

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

The components of basic and diluted earnings per share were as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
(in thousands, except per share data)				
Basic earnings per share:				
Net income (loss)	\$411	\$ (964)	\$ (1,071)	\$ (3,536)
Shares used in computation:				
Weighted average common shares outstanding	29,510,287	28,748,348	29,383,502	28,173,798
Basic earnings per share	\$0.01	\$ (0.03)	\$ (0.04)	\$ (0.13)
Diluted earnings per share:				
Net income (loss)	\$411	\$ (964)	\$ (1,071)	\$ (3,536)
Shares used in computation:				
Weighted average common shares outstanding	29,510,287	28,748,348	29,383,502	28,173,798
Stock options	2,511,042	—	—	—
Restricted stock awards and units	351,668	—	—	—
Warrants	361,037	—	—	—
Weighted average number of shares	32,734,784	28,748,348	29,383,502	28,173,798
Diluted earnings per share	\$0.01	\$ (0.03)	\$ (0.04)	\$ (0.13)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Stock options	1,035,163	4,338,867	4,207,577	4,338,867
Restricted stock awards and units	—	472,238	351,668	472,238
Warrants	—	869,999	810,000	869,999

3. Investment Securities

The amortized cost, gross unrealized holding gains and losses, and fair value of available-for-sale and short-term investments by major security type and class of security were as follows as of June 30, 2017 and December 31, 2016 (in thousands):

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
As of June 30, 2017				
Available-for-sale:				
Foreign deposits	\$ 1,829	\$ —	\$ —	\$ 1,829
Municipal bond	1,000	—	—	1,000
	\$ 2,829	\$ —	\$ —	\$ 2,829
Short-term investments:				
U.S. treasury securities	\$ 5,786	\$ —	\$ (3)	\$ 5,783
Certificates of deposit	709	1	—	710
U.S. government funds	26,070	—	—	26,070
	\$ 32,565	\$ 1	\$ (3)	\$ 32,563

	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
As of December 31, 2016				
Available-for-sale:				
Foreign deposits	\$ 1,587	\$ —	\$ —	\$ 1,587
Municipal bond	1,000	—	(8)	992
	\$ 2,587	\$ —	\$ (8)	\$ 2,579
Short-term investments:				
U.S. treasury securities	\$ 5,791	\$ —	\$ —	\$ 5,791
Certificates of deposit	707	—	—	707
U.S. government funds	23,072	—	—	23,072
	\$ 29,570	\$ —	\$ —	\$ 29,570

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

	June 30, 2017	
	Amortized Cost	Fair Value
Available-for-sale:		
Due under one year	\$—	\$—
Due after one year through five years	1,829	1,829
Due after five years through ten years	1,000	1,000
Due after ten years	—	—
	\$2,829	\$2,829

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

4. Fair Value

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

As of June 30, 2017			
	Fair Value	Level 1	Level 2
Assets			
Restricted cash	\$600	\$600	\$—
Foreign deposits	1,829	1,829	—
Municipal bond	1,000	—	1,000
Money market funds	4,871	4,871	—
Total	\$8,300	\$7,300	\$1,000

As of December 31, 2016			
	Fair Value	Level 1	Level 2
Assets			
Restricted cash	\$600	\$600	\$—
Foreign deposits	1,587	1,587	—
Municipal bond	992	—	992
Money market funds	7,033	7,033	—
Total	\$10,212	\$9,220	\$992

The Company measures the fair value of restricted cash, foreign deposits, and money market funds based on quoted prices in active markets for identical assets. The fair value of the municipal bond is based on either recent trades in inactive markets or quoted market prices of similar instruments and other significant inputs derived from or corroborated by observable market data.

As of June 30, 2017, the Company's other long-term assets balance included a \$2.6 million note receivable, recorded at its estimated collectible amount, plus accrued interest. The Company estimates that the carrying value of the note receivable approximates the fair value. The estimated fair value represents a Level 3 measurement within the fair value hierarchy, and is based on market interest rates and the assessed creditworthiness of the third party.

The Company estimates the fair value of long-term debt based upon rates currently available to the Company for debt with similar terms and remaining maturities. This is a Level 3 measurement. Based upon the terms of the debt, the carrying amount of long-term debt approximated fair value at June 30, 2017 and December 31, 2016.

5. Debt

The Company has a revolving line of credit, secured by any and all interests in the Company's assets that are not otherwise restricted. Interest on the revolving line of credit is payable monthly at the greater of 4.5%, or 1.25% plus the prime rate. As of June 30, 2017 and December 31, 2016, borrowings on the revolving line of credit were limited to the lesser of \$30.0 million and the total amount of cash and securities held by the Company's insurance subsidiaries (American Pet Insurance Company and Wyndham Insurance Company (SAC) Ltd. Segregated Account AX). The borrowing agreement includes other ancillary services and letters of credit of up to \$4.5 million and \$3.0 million as of June 30, 2017 and December 31, 2016, respectively. The Company's outstanding balance for ancillary services and letters of credit of \$1.5 million as of June 30, 2017 and \$1.6 million as of December 31, 2016, reduces available borrowing capacity on the line of credit. The facility also requires a deposit of restricted cash of \$0.6 million. The agreement was most recently amended in March 2017 to extend the maturity date to December 2019. The credit agreement requires the Company to comply with various financial and non-financial covenants. As of June 30, 2017 and December 31, 2016, the Company was in compliance with all covenants.

As of June 30, 2017, the Company's outstanding borrowings under this facility were \$6.5 million, recorded net of financing fees of \$0.2 million, with \$22.0 million remaining available to borrow.

6. Commitments and Contingencies

From time to time, the Company is subject to litigation matters and claims arising from the ordinary course of business. The Company records a provision for a liability relating to legal matters when it is both probable that a material liability has been incurred and the amount of the loss can be reasonably estimated. At this time, the Company does not believe any such matters to be material individually or in the aggregate. These views are subject to change following the outcome of future events or the results of future developments.

7. Stock-Based Compensation

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

	Number Of Options	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)
Outstanding as of December 31, 2016	4,123,023	\$ 5.06	\$ 43,185
Granted	628,589	17.47	
Exercised	(494,970)	3.33	6,601
Forfeited	(49,065)	10.22	
Outstanding as of June 30, 2017	4,207,577	7.05	64,482

Vested and Exercisable at June 30, 2017 2,871,578 \$ 3.67 \$ 53,737

As of June 30, 2017, the stock options outstanding had a weighted-average remaining contractual life of 5.9 years. Stock-based compensation expense includes stock options and restricted stock awards and units granted to employees and non-employees and has been reported in the Company's consolidated statements of operations as follows (in thousands):

	Three Months Ended June 30, 2017		Six Months Ended June 30, 2017	
	2017	2016	2017	2016
	(in thousands)			
Claims expenses	\$89	\$57	\$159	\$115
Other cost of revenue	60	9	103	17
Sales and marketing	198	165	385	247
Technology and development	59	36	109	91
General and administrative	482	476	913	969
Total stock-based compensation expense	\$888	\$743	\$1,669	\$1,439

As of June 30, 2017, the Company had 1,335,999 unvested stock options and 351,668 restricted stock awards and units that are expected to vest. Total stock-based compensation expense of \$7.8 million related to these unvested awards is expected to be recognized over a weighted-average period of approximately 2.7 years.

8. Claims Reserve

The claims reserve includes unpaid claims and claims adjustment expenses and an estimate of claims that have been incurred but not yet reported (IBNR) to the Company. The estimate, which involves actuarial projections, is based on management's assessment of facts and circumstances currently known, and assumptions about anticipated claims patterns, including expected future trends in claims severity and frequency. Reserve estimates are continually refined as claims are reported and settled. Changes in management's assumptions and estimates may have a relatively large impact to the claims reserve and associated expense.

This estimate is made for each of the Company's two segments, subscription business and other business. The subscription business segment includes monthly subscriptions related to the Company's medical plan which are marketed directly to consumers, while the other business segment includes all other business that is not directly marketed to consumers.

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

	Six Months Ended June 30,	
	2017	2016
	(in thousands)	
Claims reserve at beginning of year	\$8,538	\$5,384
Claims incurred during the period related to:		
Current year	74,244	58,162
Prior years	(257)	459
Total claims incurred	73,987	58,621
Claims paid during period related to:		
Current year	65,549	51,844
Prior years	7,138	5,415
Total claims paid	72,687	57,259
Non-cash claims expense	229	187
Claims reserve at end of period	\$9,609	\$6,559

The Company's claim reserve for the subscription business segment increased \$1.1 million from \$8.5 million at December 31, 2016 to \$9.6 million at June 30, 2017. This change was comprised of \$74.0 million in claims expense incurred during the period less \$72.7 million in claims expense paid during the period. The \$74.0 million in claims expense incurred includes a reduction of \$0.3 million to the reserves relating to prior years. The change is the result of ongoing analysis of recent claims trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

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

	Six Months Ended June 30,	
	2017	2016
	(in thousands)	
Claims reserve at beginning of year	\$983	\$890
Claims incurred during the period related to:		
Current year	6,337	4,427
Prior years	(128)	22
Total claims incurred	6,209	4,449
Claims paid during period related to:		
Current year	5,217	3,484
Prior years	764	832
Total claims paid	5,981	4,316
Non-cash claims expense	—	—
Claims reserve at end of period	\$1,211	\$1,023

The Company's claim reserve for the other business segment increased \$0.2 million from \$1.0 million at December 31, 2016 to \$1.2 million at June 30, 2017. This change was comprised of \$6.2 million in claims expense incurred during the period less \$6.0 million in claims expense paid during the period. The \$6.2 million in claims expense incurred includes a reduction of \$0.1 million to the reserves relating to prior years. The change is the result of ongoing analysis of recent claims trends. Original estimates are increased or decreased as additional information becomes known regarding individual claims.

Claims Reserve by Loss Year

The total claims reserve as of June 30, 2017 for the subscription business segment relates to activity incurred during the years as follows (in thousands):

	As of
	June
	30,
	2017
Year Incurred	
2015	\$229
2016	913
2017	8,467
	\$9,609

The total claims reserve as of June 30, 2017 for the other business segment relates to activity incurred during the years as follows (in thousands):

	As of
	June
	30,
	2017
Year Incurred	
2015	\$2
2016	88
2017	1,121
	\$1,211

9. Equity Method Investment

In June 2017, the Company sold its share of an investment previously accounted for under the equity method. The sale resulted in a gain of \$1.0 million recorded within other income on the consolidated statement of operations.

10. Segments

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

The chief operating decision maker uses two measures to evaluate segment performance: revenue and gross profit. Additionally, other operating expenses, such as sales and marketing expenses, are allocated to each segment and evaluated when material. Interest and other expenses and income taxes are not allocated to the segments, nor included in the measure of segment profit or loss. The Company does not analyze discrete segment balance sheet information related to long-term assets.

Revenue and gross profit of the Company's segments were as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Revenue:				
Subscription business	\$52,641	\$42,162	\$102,870	\$81,305
Other business	5,634	3,670	10,134	7,226
	58,275	45,832	113,004	88,531
Claims expenses:				
Subscription business	37,664	30,111	73,987	58,621
Other business	3,345	2,355	6,209	4,449
	41,009	32,466	80,196	63,070
Other cost of revenue:				
Subscription business	4,927	4,047	9,850	7,740
Other business	1,988	1,053	3,452	2,151
	6,915	5,100	13,302	9,891
Gross profit:				
Subscription business	10,050	8,004	19,033	14,944
Other business	301	262	473	626
	10,351	8,266	19,506	15,570
Sales and marketing:				
Subscription business	4,309	3,509	8,350	7,311
Other business	63	55	111	93
	4,372	3,564	8,461	7,404
Technology and development	2,322	2,164	4,725	4,451
General and administrative	4,245	3,495	8,257	7,217
Operating loss	\$(588)	\$(957)	\$(1,937)	\$(3,502)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
United States	\$47,306	\$36,748	\$91,440	\$71,225
Canada	10,969	9,084	21,564	17,306
Total revenue	\$58,275	\$45,832	\$113,004	\$88,531

Substantially all of the Company's long-lived assets were located in the United States as of June 30, 2017 and December 31, 2016.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Overview

We provide a medical insurance plan for cats and dogs throughout the United States, Canada and Puerto Rico. Our data-driven, vertically-integrated approach enables us to provide pet owners with what we believe is the highest value medical plan for their pets, using a pricing model that is based on the estimated cost specific to each pet's unique characteristics plus a standard margin. Our growing and loyal member base provides us with highly predictable and recurring revenue. We operate our business similar to other subscription-based businesses, with a focus on maximizing the lifetime value of each pet while sustaining a favorable ratio of lifetime value relative to pet acquisition cost, based on our desired return on investment.

We operate in two business segments: subscription business and other business. We generate revenue in our subscription business segment primarily from subscription fees for our medical plan, which we market to consumers. Our medical plan automatically renews on a monthly basis and members pay the subscription fee at the beginning of each subscription period, in most cases by authorizing us to directly charge their credit card, debit card or bank account through automatic funds transfer. Subscription revenue is recognized on a pro rata basis over the monthly enrollment term. We generate revenue in our other business segment primarily from writing policies on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that provide different coverage and may have materially different terms and conditions than our subscription medical plan. We generate leads for our subscription business through both third-party referrals and direct-to-consumer acquisition channels, which we then convert into members through our website and contact center. Veterinary practices represent our largest referral source. We engage a national referral network of partners, which we refer to as our Territory Partners, who are paid fees based on activity in their regions. Our Territory Partners are dedicated to cultivating direct veterinary relationships and building awareness of the benefits that our medical plan offers veterinarians and their clients. Veterinarians then educate pet owners, who visit our website or call our contact center to learn more about, and potentially enroll in, our medical plan. We also receive a significant number of new leads from existing members adding pets and referring their friends and family members. Our direct-to-consumer acquisition channels serve as important resources for pet owner education and drive new member leads and conversion. We continuously evaluate the effectiveness of our member acquisition channels and marketing initiatives based upon their return on investment, which we measure by comparing the ratio of the lifetime value of a pet generated through each specific channel or initiative to the related acquisition cost.

Our revenue increased from \$88.5 million for the six months ended June 30, 2016 to \$113.0 million for the six months ended June 30, 2017, representing 28% year-over-year growth. We have made and expect to continue to make substantial investments in member acquisition and in expanding our operations. For the six months ended June 30, 2017 and 2016, we had a net loss of \$1.1 million and \$3.5 million, respectively. As of June 30, 2017, our accumulated deficit was \$82.4 million.

Key Operating Metrics

The following tables set forth our key operating metrics for the six-month periods ended June 30, 2017 and 2016 and for each of the last eight fiscal quarters.

	Six Months Ended June 30,	
	2017	2016
Total pets enrolled (at period end)	383,293	320,896
Total subscription pets enrolled (at period end)	346,409	299,856
Monthly average revenue per pet	\$50.99	\$46.77
Lifetime value of a pet (LVP)	\$654	\$622
Average pet acquisition cost (PAC)	\$135	\$120
Average monthly retention	98.57 %	98.64 %

	Three Months Ended							
	Jun. 30, 2017	Mar. 31, 2017	Dec. 31, 2016	Sept. 30, 2016	Jun. 30, 2016	Mar. 31, 2016	Dec. 31, 2015	Sept. 30, 2015
Total pets enrolled (at period end)	383,293	364,259	343,649	334,070	320,896	307,298	291,818	276,988
Total subscription pets enrolled (at period end)	346,409	334,909	323,233	312,282	299,856	287,123	272,636	258,546
Monthly average revenue per pet	\$51.47	\$50.50	\$49.17	\$48.37	\$47.39	\$46.12	\$45.48	\$45.15
Lifetime value of a pet (LVP)	\$654	\$637	\$631	\$624	\$622	\$603	\$591	\$591
Average pet acquisition cost (PAC)	\$143	\$128	\$133	\$120	\$118	\$123	\$132	\$129
Average monthly retention	98.57 %	98.58 %	98.60 %	98.61 %	98.64 %	98.65 %	98.64 %	98.66 %

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

Total subscription pets enrolled. Total subscription pets enrolled reflects the number of pets subscribed to the plan marketed by us to consumers at the end of each period presented. We monitor total subscription pets enrolled because it provides an indication of the growth of our subscription business.

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

Lifetime value of a pet. Lifetime value of a pet (LVP) is calculated in part based on the average monthly gross profit from our subscription business segment for the 12 months prior to the period end date excluding stock-based compensation expense related to cost of revenue from our subscription business segment, sign-up fee revenue and the change in deferred revenue between periods, multiplied by the implied average subscriber life in months. Implied average subscriber life in months is calculated as the quotient obtained by dividing one by one minus the average monthly retention rate. We monitor LVP to assess how much lifetime value we might expect from new pets over their implied average subscriber life in months and to evaluate the amount of sales and marketing expenses we may want to incur to attract new pet enrollments.

Average pet acquisition cost. Average pet acquisition cost (PAC) is calculated as net acquisition cost divided by the total number of new subscription pets enrolled in that period. Net acquisition cost, a non-GAAP financial measure, is calculated in a reporting period as sales and marketing expenses, excluding stock-based compensation expense, offset by sign-up fee revenue and other business segment sales and marketing expenses. We offset sales and marketing expenses with sign-up fee revenue since it is a one-time charge to new members used to partially offset initial setup costs, which are included in sales and marketing expenses. We monitor average pet acquisition cost to evaluate the efficiency of our sales and marketing programs and measure return on acquisition spend.

Average monthly retention. Average monthly retention is measured as the monthly retention rate of enrolled subscription pets for each applicable period averaged over the 12 months prior to the period end date. As such, our average monthly retention rate as of June 30, 2017 is an average of each month's retention from July 1, 2016 through June 30, 2017. We calculate monthly retention as the number of pets that remain after subtracting all pets that cancel during a month, including pets that enroll and cancel within that month, divided by the total pets enrolled at the beginning of that month. We monitor average monthly retention because it provides a measure of member satisfaction and allows us to calculate the implied average subscriber life in months.

Non-GAAP Financial Measures

We believe that using acquisition cost and net acquisition cost to calculate and present certain of our other key metrics is helpful to our investors. These measures, which are non-GAAP financial measures, are not prepared in accordance with U.S. GAAP. We define acquisition cost as sales and marketing expenses, excluding stock-based compensation expense. We define net acquisition cost as acquisition cost net of sign-up fee revenue and other business segment sales and marketing expenses.

Our non-GAAP financial measures may not provide information that is directly comparable to that provided by other companies in our industry as other companies in our industry may calculate or use non-GAAP financial measures differently. In addition, there are limitations in using non-GAAP financial measures because the non-GAAP financial measures are not prepared in accordance with GAAP, may be different from non-GAAP financial measures used by other companies and exclude expenses that may have a material impact on our reported financial results. The presentation and utilization of non-GAAP financial measures is not meant to be considered in isolation or as a substitute for the directly comparable financial measures prepared in accordance with GAAP. We urge our investors to review the reconciliation of our non-GAAP financial measures to the most directly comparable GAAP financial measures in our consolidated financial statements that is included below, and not to rely on any single financial or operating measure to evaluate our business.

Because of varying available valuation methodologies, subjective assumptions and the variety of equity instruments that can impact a company's non-cash expenses, we believe that providing non-GAAP financial measures such as acquisition cost and net acquisition cost, allows for more meaningful comparisons between our operating results from period to period. We net sign-up fees with sales and marketing expenses in our calculation of net acquisition cost because we collect it from new members at the time of enrollment and consider it to be an offset to a portion of our sales and marketing expenses. We believe this allows us to calculate and present acquisition cost, net acquisition cost and the related financial measures we derive from them, in a consistent manner across periods. Our non-GAAP financial measures and the related financial measures we derive from them are important tools for financial and operational decision-making and for evaluating our own operating results over different periods of time.

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

	Six Months Ended June 30, 2017 2016 (in thousands)								
Sales and marketing expense	\$8,461	\$7,404							
Excluding:									
Stock-based compensation expense	(385)	(247)							
Acquisition cost	8,076	7,157							
Net of:									
Sign-up fee revenue	(1,061)	(1,022)							
Other business segment sales and marketing expense	(111)	(93)							
Net acquisition cost	\$6,904	\$6,042							
	Three Months Ended								
	Jun. 30, 2017	Mar. 31, 2017	Dec. 31, 2016	Sept. 30, 2016	Jun. 30, 2016	Mar. 31, 2016	Dec. 31, 2015	Sept. 30, 2015	
	(in thousands)								
Sales and marketing expense	\$4,372	\$4,089	\$3,951	\$3,892	\$3,564	\$3,840	\$3,919	\$4,128	
Excluding:									
Stock-based compensation expense	(198)	(187)	(113)	(172)	(165)	(82)	(104)	(102)	
Acquisition cost	4,174	3,902	3,838	3,720	3,399	3,758	3,815	4,026	
Net of:									
Sign-up fee revenue	(517)	(544)	(526)	(525)	(495)	(527)	(506)	(542)	
Other business segment sales and marketing expense	(63)	(48)	(62)	(63)	(55)	(38)	(8)	(16)	
Net acquisition cost	\$3,594	\$3,310	\$3,250	\$3,132	\$2,849	\$3,193	\$3,301	\$3,468	

Factors Affecting Our Performance

Average monthly retention. Our performance depends on our ability to continue to retain our existing and newly enrolled pets and is impacted by our ability to provide a best-in-class value and member experience. Our ability to maintain the retention rate of enrolled pets may be affected by a number of factors, including the actual and perceived value of our services and the quality of our member experience, our claims payment process and the competitive environment. In addition, if the number of new pets enrolled increases at a faster rate than our historical experience, our average monthly retention rate could be adversely impacted, as our retention rate is generally lower during the first year of member enrollment.

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

Timing of initiatives. Over time we plan to implement new initiatives to improve our member experience, make modifications to our medical plan and find other ways to maintain a strong value proposition for our members. These initiatives will sometimes be accompanied by price adjustments, in order to compensate for an increase in benefits

received by our members.

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The implementation of such initiatives may not always coincide with the timing of price adjustments, resulting in fluctuations in revenue and gross profit in our subscription business segment.

Geographic mix of sales. The relative mix of our business between the United States and Canada impacts the monthly average revenue per pet we receive. Prices for our plan in Canada are generally higher than in the United States (in local currencies), which is consistent with the relative cost of veterinary care in each country. As our revenue has grown faster in the United States compared to Canada, this geographic shift in the mix of business has reduced the growth in our monthly average revenue per pet. In addition, as our mix of revenue changes between the United States and Canada, our exposure to foreign exchange fluctuations will be impacted.

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

Basis of Presentation

General

We operate in two business segments: subscription business and other business. Our subscription business segment includes revenue and expenses related to monthly subscriptions for our medical plan, which we market to consumers. Our other business segment includes revenue and expenses related to our other operations that are not directly marketed to consumers. We report our financial information in accordance with U.S. GAAP.

Revenue

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

We generate revenue in our other business segment primarily from writing policies on behalf of third parties where we do not undertake the direct consumer marketing. This segment includes the writing of policies that provide different coverage and may have materially different terms and conditions than our subscription medical plan.

Cost of Revenue

Cost of revenue in each of our segments is comprised of claims expenses and other cost of revenue.

Claims expenses

Claims expenses include claims incurred, the cost of personnel administering the claims and providing member service relating to claims, and other operating expenses directly or indirectly related to claims administration. Claims incurred are the claims approved for payment plus an accrual for claims incurred that have not yet been submitted or approved for payment. This accrual is based on our historical experience and developments in claims frequency and severity and the cost of veterinary care, and also includes the cost of administering such claims.

Other cost of revenue

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

For both our subscription business and our other business segments, we generally expect our cost of revenue to remain relatively constant as a percentage of revenue, although there may be some periodic variability due to a number of factors including the rate of claims occurrences during such periods. Claims expenses as a percentage of our

subscription business revenue may increase over the long-term as part of our strategy to return more value to our members to further enhance our member experience, retention rates and lifetime value of a pet. We currently expect that, in the long-term, such increases generally would be offset by economies of scale in our other cost of revenue.

Gross Profit

Gross profit is total revenue less cost of revenue. We expect gross profit as a percentage of revenue in our subscription segment to remain relatively consistent in the long-term, although there has been and may be in the future some periodic variability due to a number of factors, including the rate of claims occurrences during such periods and in the timing and significance of our pricing adjustments. The timing of our implementation of various initiatives to improve the experience of our members also may affect gross profit in the short-term. Further, as the mix of subscription business and other business changes and as we add or modify relationships in our other business segment, this may impact our total gross profit as a percentage of revenue.

Operating Expenses

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

Sales and Marketing

Sales and marketing expenses primarily consist of the cost to generate and convert a lead to an enrolled pet; print, online and promotional advertising costs; strategic partnership fees and personnel costs and related expenses. Sales and marketing expenses are driven primarily by investments to acquire new members. We plan to continue to invest in existing and new member acquisition channels and marketing initiatives to grow our business. Investments made in testing new member acquisition initiatives are generally more expensive than our traditional marketing channels and increase our average pet acquisition cost. We manage our sales and marketing expense on a per pet basis. As such, we expect sales and marketing expenses to fluctuate in absolute values and as a percentage of revenue based on how many new pets are enrolled in a period as well as the average pet acquisition cost. We base our sales and marketing spend on what we determine to be the appropriate ratio of lifetime value of a pet to average pet acquisition cost which is based on our desired return on our investment.

Technology and Development

Technology and development expenses primarily consist of personnel costs and related expenses for our operations staff, which includes information technology development and infrastructure support, third-party services and depreciation of hardware and capitalized software and amortization of intangible assets. We expect technology and development expenses to decrease as a percentage of revenue as we continue to experience scale in our technology expenses.

General and Administrative

General and administrative expenses consist primarily of personnel costs and related expenses for our finance, actuarial, human resources, regulatory, legal, general management functions, as well as facilities and professional services. We expect general and administrative expenses to decrease as a percentage of revenue as we continue to experience scale in our general and administrative expenses.

Results of Operations

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

	Three Months Ended June 30, 2017 2016		Six Months Ended June 30, 2017 2016	
	(in thousands)			
Consolidated Statement of Operations Data:				
Revenue:				
Subscription business	\$52,641	\$42,162	\$102,870	\$81,305
Other business	5,634	3,670	10,134	7,226
Total revenue	58,275	45,832	113,004	88,531
Cost of revenue:				
Subscription business ⁽¹⁾	42,591	34,158	83,837	66,361
Other business	5,333	3,408	9,661	6,600
Total cost of revenue	47,924	37,566	93,498	72,961
Gross profit:				
Subscription business	10,050	8,004	19,033	14,944
Other business	301	262	473	626
Total gross profit	10,351	8,266	19,506	15,570
Operating expenses:				
Sales and marketing ⁽¹⁾	4,372	3,564	8,461	7,404
Technology and development ⁽¹⁾	2,322	2,164	4,725	4,451
General and administrative ⁽¹⁾	4,245	3,495	8,257	7,217
Total operating expenses	10,939	9,223	21,443	19,072
Operating loss	(588)	(957)	(1,937)	(3,502)
Interest expense	109	41	246	71
Other (income) expense, net	(1,112)	(38)	(1,140)	(55)
Income (loss) before income taxes	415	(960)	(1,043)	(3,518)
Income tax expense	4	4	28	18
Net income (loss)	\$411	\$(964)	\$(1,071)	\$(3,536)

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
	(in thousands)			
Cost of revenue	\$149	\$66	\$262	\$132
Sales and marketing	198	165	385	247
Technology and development	59	36	109	91
General and administrative	482	476	913	969
Total stock-based compensation expense	\$888	\$743	\$1,669	\$1,439

	Three Months		Six Months	
	Ended June		Ended June	
	30,	30,	30,	30,
	2017	2016	2017	2016
	(as a % of revenue)			
Revenue	100 %	100 %	100 %	100 %
Cost of revenue	82	82	83	82
Gross profit	18	18	17	18
Operating expenses:				
Sales and marketing	8	8	7	8
Technology and development	4	5	4	5
General and administrative	7	8	7	8
Total operating expenses	19	20	19	22
Operating loss	(1)	(2)	(2)	(4)
Interest expense	—	—	—	—
Other income, net	(2)	—	(1)	—
Income (loss) before income taxes	1	(2)	(1)	(4)
Income tax expense	—	—	—	—
Net income (loss)	1 %	(2)%	(1)%	(4)%

	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2017	2016	2017	2016
	(as a % of subscription revenue)			
Subscription business revenue	100 %	100 %	100 %	100 %
Subscription business cost of revenue	81	81	81	82
Subscription business gross profit	19 %	19 %	19 %	18 %

Comparison of Three and Six Months Ended June 30, 2017 and 2016

Revenue

	Three Months Ended June 30,		% Change		Six Months Ended June 30,		% Change
	2017	2016			2017	2016	
	(in thousands, except percentages, pet and per pet data)						
Revenue:							
Subscription business	\$52,641	\$42,162	25 %		\$102,870	\$81,305	27 %
Other business	5,634	3,670	54		10,134	7,226	40
Total revenue	\$58,275	\$45,832	27		\$113,004	\$88,531	28
Percentage of Revenue by Segment:							
Subscription business	90	% 92	%		91	% 92	%
Other business	10	8			9	8	
Total revenue	100	% 100	%		100	% 100	%
							&