

TRUPANION INC.
Form 10-Q
November 04, 2016

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 September 30, 2016

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, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting 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 ☐

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 October 26, 2016 there were approximately 29,253,857 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 for share and per share data)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	\$48,359	\$ 37,865	\$ 136,890	\$ 106,762
Cost of revenue:				
Claims expenses	34,253	26,604	97,323	75,442
Other cost of revenue	5,606	4,670	15,497	13,361
Gross profit	8,500	6,591	24,070	17,959
Operating expenses:				
Sales and marketing	3,892	4,128	11,296	11,312
Technology and development	2,339	3,005	6,790	8,683
General and administrative	3,811	4,067	11,028	11,760
Total operating expenses	10,042	11,200	29,114	31,755
Operating loss	(1,542)	(4,609)	(5,044)	(13,796)
Interest expense	66	14	137	298
Other expense (income), net	16	4	(39)	8
Loss before income taxes	(1,624)	(4,627)	(5,142)	(14,102)
Income tax expense	13	16	31	102
Net loss	\$(1,637)	\$(4,643)	\$(5,173)	\$(14,204)
Net loss per share attributable to common stockholders:				
Basic and diluted	\$(0.06)	\$(0.17)	\$(0.18)	\$(0.52)
Weighted-average shares used to compute net loss per share attributable to common stock holders:				
Basic and diluted	28,732,417	27,755,310	28,362,084	27,564,975

Trupanion, Inc.

Consolidated Statements of Comprehensive Loss

(in thousands)

(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net loss	\$ (1,637)	\$ (4,643)	\$ (5,173)	\$ (14,204)
Other comprehensive (loss) income:				
Foreign currency translation adjustments	(96)	(274)	204	(347)
Change in unrealized losses on available-for-sale securities	25	29	33	(12)
Other comprehensive (loss) income, net of taxes	(71)	(245)	237	(359)
Comprehensive loss	\$ (1,708)	\$ (4,888)	\$ (4,936)	\$ (14,563)

Trupanion, Inc.

Consolidated Balance Sheets

(in thousands, except for share data)

	September 30, 2016	December 31, 2015
	(unaudited)	
Assets		
Current assets:		
Cash and cash equivalents	\$ 20,626	\$ 17,956
Short-term investments	28,720	25,288
Accounts and other receivables	10,286	8,196
Prepaid expenses and other assets	1,919	2,193
Total current assets	61,551	53,633
Long-term investments, at fair value	2,500	2,388
Equity method investment	289	300
Property and equipment, net	9,188	9,719
Intangible assets, net	4,894	4,854
Other long term assets	89	23
Total assets	\$ 78,511	\$ 70,917
Liabilities and stockholders' equity		
Current liabilities:		
Accounts payable	\$ 1,284	\$ 1,289
Accrued liabilities	3,489	4,189
Claims reserve	8,362	6,274
Deferred revenue	13,171	11,042
Deferred tax liabilities	169	169
Other payables	987	654
Total current liabilities	27,462	23,617
Long-term debt	3,969	—
Deferred tax liabilities	1,433	1,433
Other liabilities	858	511
Total liabilities	33,722	25,561
Stockholders' equity:		
Common stock, \$0.00001 par value per share, 100,000,000 shares authorized at September 30, 2016 and 200,000,000 shares authorized at December 31, 2015, 29,870,771 and 29,249,792 shares issued and outstanding at September 30, 2016; 29,017,168 and 28,396,189 shares issued and outstanding at December 31, 2015	—	—
Preferred stock: \$0.00001 par value per share, 10,000,000 shares authorized at September 30, 2016 and December 31, 2015, and 0 shares issued and outstanding at September 30, 2016 and December 31, 2015	—	—
Additional paid-in capital	127,213	122,844
Accumulated other comprehensive loss	(265) (502
Accumulated deficit	(79,558) (74,385
Treasury stock, at cost: 620,979 shares at September 30, 2016 and December 31, 2015	(2,601) (2,601
Total stockholders' equity	44,789	45,356
Total liabilities and stockholders' equity	\$ 78,511	\$ 70,917

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

	Nine Months Ended September 30,	
	2016	2015
Operating activities		
Net loss	\$(5,173)	\$(14,204)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Depreciation and amortization	2,617	1,800
Stock-based compensation expense	2,215	2,349
Other, net	218	(86)
Changes in operating assets and liabilities:		
Accounts and other receivables	(2,023)	(504)
Prepaid expenses and other assets	217	(868)
Accounts payable	(31)	(329)
Accrued liabilities	(700)	53
Claims reserve	2,043	1,127
Deferred revenue	2,079	1,310
Other payables	106	(416)
Net cash provided by (used in) operating activities	1,568	(9,768)
Investing activities		
Purchases of investment securities	(15,992)	(16,082)
Maturities of investment securities	12,577	13,580
Equity method investment	—	(300)
Purchases of property and equipment	(1,546)	(3,816)
Other	(130)	—
Net cash used in investing activities	(5,091)	(6,618)
Financing activities		
Tax withholding on restricted stock	(662)	(643)
Proceeds from exercise of stock options	2,736	914
Proceeds from (repayment of) debt financing	3,988	(14,900)
Payments on capital lease obligations	(110)	—
Net cash provided by (used in) financing activities	5,952	(14,629)
Effect of foreign exchange rates on cash, net	241	(395)
Net change in cash and cash equivalents	2,670	(31,410)
Cash and cash equivalents at beginning of period	17,956	53,098
Cash and cash equivalents at end of period	\$20,626	\$21,688
Supplemental disclosures		
Income taxes paid	12	117
Interest paid	92	155
Noncash investing and financing activities:		
Increase in payables for property and equipment	81	310
Property and equipment acquired under capital leases	615	—

Trupanion, Inc.

Notes to the Consolidated Financial Statements (unaudited)

1. Nature of Operations and Summary of Significant Accounting Policies

Description of Business

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

Basis of Presentation

The consolidated balance sheet data as of December 31, 2015 was derived from audited consolidated financial statements. The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (U.S. GAAP) for unaudited consolidated financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete financial statements. The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. These unaudited consolidated financial statements and notes should be read in conjunction with the Company's audited consolidated financial statements and accompanying notes for the year ended December 31, 2015 included in the Company's Annual Report on Form 10-K, filed with the U.S. Securities and Exchange Commission on February 17, 2016. The accompanying unaudited consolidated financial statements reflect all adjustments consisting of normal recurring adjustments which, in the opinion of management, are necessary for a fair presentation of the Company's financial position and results of its operations, as of and for the periods presented. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016, or for any other period.

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 reported amounts of assets and liabilities and disclosure of contingencies and the reported amounts of revenue and expenses. Significant items subject to such estimates and assumptions include the valuation of deferred tax assets, stock-based compensation, claims reserve, useful lives of software developed for internal use and income tax uncertainties. Actual results could differ from the estimates used in preparing the consolidated financial statements.

Accumulated Other Comprehensive Loss

There were no reclassifications out of accumulated other comprehensive loss during the three and nine months ended September 30, 2016 and 2015.

Recent Accounting Pronouncements

In May 2015, the Financial Accounting Standards Board (FASB) issued an Accounting Standards Update (ASU) amending short-term insurance contract disclosures and requiring more detailed disclosures to enable users of financial statements to understand information relating to liabilities for unpaid claims and claims adjustment expenses. Additionally, the amendments will also require insurance entities to disclose information about significant changes in methodologies and assumptions used to calculate these liabilities. This guidance is effective for annual reporting periods beginning after December 15, 2015 and interim periods beginning after December 15, 2016. Early adoption of this guidance is permitted, and must be applied retrospectively by providing comparative disclosures for each period presented. The Company plans to adopt this guidance as of December 31, 2016. The Company has determined that although this guidance will not impact the operating results, financial condition or cash flows, additional disclosures will be required in the Company's Form 10-K and Form 10-Q upon adoption.

In November 2015, the FASB issued an ASU amending the accounting for income taxes and requiring all deferred tax assets and liabilities be classified as non-current on the consolidated balance sheet. The ASU is effective for reporting periods beginning after December 15, 2016, with early adoption permitted. The ASU may be adopted either prospectively or retrospectively. The Company plans to prospectively adopt this guidance as of January 1, 2017. The Company anticipates that this guidance will not have a material impact on the financial statements resulting from the reclassification of deferred taxes to non-current. The Company will continue to monitor the impact of this guidance.

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 balance sheet. 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 is in the process of assessing the impact of this guidance.

In March 2016, the FASB issued an ASU amending the accounting for employee share-based payments, including income tax recognition and classification. The entity may make an entity-wide accounting policy election to either estimate the number of awards that are expected to vest or account for forfeitures when they occur. Additionally, tax withholding of shares will be allowed up to the employees' maximum individual tax rate in the relevant jurisdiction without resulting in liability classification of the award. This ASU is effective for fiscal years beginning after December 15, 2016 including interim periods within that reporting period, with early adoption permitted. The Company plans to adopt this guidance as of January 1, 2017. The Company has determined the guidance for estimating forfeitures does not currently have a material impact to the financial statements; however, the Company will continue to monitor the impact of this guidance.

In August 2016, the FASB issued an ASU which addresses eight specific cash flow issues intended to reduce diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. This ASU is effective for fiscal periods beginning after December 15, 2017 including interim periods within that reporting period, with early adoption permitted. The Company plans to adopt this guidance as of January 1, 2018. The Company is in the process of assessing the impact of this guidance.

2. Net Loss per Share

Basic net loss per share is calculated by dividing the net loss by the weighted-average number of shares of common stock outstanding for the period. Excluded from the weighted-average number of shares outstanding are shares that have been issued and are subject to future vesting and unvested restricted stock. Diluted net loss per share is calculated by dividing the net loss by the weighted-average number of common stock equivalents outstanding for the period determined using the treasury-stock method. Potentially dilutive common stock equivalents are comprised of unvested restricted stock, stock options, and warrants. For all periods presented, there is no difference in the number of shares used to calculate basic and diluted shares outstanding due to the Company's net loss position.

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

	As of September 30,	
	2016	2015
Stock options	4,354,494	4,991,047
Restricted stock awards and units	355,329	474,522
Warrants	869,999	869,999

3. Investment Securities

The amortized cost, gross unrealized holding 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 September 30, 2016 and December 31, 2015 (in thousands):

	Amortized Cost	Gross Unrealized Holding Losses	Fair Value
As of September 30, 2016			
Available-for-sale:			
Foreign deposits	\$ 1,521	\$ —	\$1,521
Municipal bond	1,000	(21)	979
	\$ 2,521	\$ (21)	\$2,500
Short-term investments:			
U.S. Treasury securities	\$ 5,786	\$ —	\$5,786
Certificates of deposit	708	—	708
U.S. government funds	22,226	—	22,226
	\$ 28,720	\$ —	\$28,720

	Amortized Cost	Gross Unrealized Holding Losses	Fair Value
As of December 31, 2015			
Available-for-sale:			
Foreign deposits	\$ 1,442	\$ —	\$1,442
Municipal bond	1,000	(54)	946
	\$ 2,442	\$ (54)	\$2,388
Short-term investments:			
U.S. Treasury securities	\$ 5,683	\$ —	\$5,683
Certificates of deposit	1,551	—	1,551
U.S. government funds	18,054	—	18,054
	\$ 25,288	\$ —	\$25,288

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

	September 30, 2016	
	Amortized Cost	Fair Value
Available-for-sale:		
Due under one year	\$—	\$—
Due after one year through five years	1,521	1,521
Due after five years through ten years	1,000	979
Due after ten years	—	—
	\$2,521	\$2,500

The Company had one investment with an unrealized loss of less than \$0.1 million and a fair value of \$1.0 million at September 30, 2016, and an unrealized loss of \$0.1 million and a fair value of \$0.9 million at December 31, 2015. The debt security has been in the unrealized loss position for more than 12 months. The Company has assessed the bond for credit impairment and has determined that there is no intent to sell this bond and it is likely that it will hold the investment for a period of time sufficient to allow for a recovery. Furthermore, future payments on this bond are

insured by a financial guarantee insurer. Therefore, the Company believes that the unrealized loss on this bond constitutes a temporary impairment.

4. Fair Value

The Company determines fair value based on assumptions that market participants would use in pricing an asset or liability in the principal or most advantageous market. The Company utilizes valuation techniques that maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible.

When considering market participant assumptions in fair value measurements, the following fair value hierarchy distinguishes between observable and unobservable inputs, which are categorized in one of the following levels:

Level 1 inputs: Unadjusted quoted prices in active markets for identical assets or liabilities accessible to the reporting entity at the measurement date.

Level 2 inputs: Valuations based on observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, or other inputs that are observable or can be corroborated by observable market data.

Level 3 inputs: Unobservable inputs for the asset or liability used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

The following table presents the placement in the fair value hierarchy of assets and liabilities that are measured at fair value on a recurring basis (in thousands):

As of September 30, 2016				
	Fair Value	Level 1	Level 2	Level 3
Assets				
Foreign deposits	\$1,521	\$1,521	\$—	\$—
Municipal bond	979	—	979	—
Money market funds	7,325	7,325	—	—
Total	\$9,825	\$8,846	\$979	\$—

As of December 31, 2015				
	Fair Value	Level 1	Level 2	Level 3
Assets				
Foreign deposits	\$1,442	\$1,442	\$—	\$—
Municipal bond	946	—	946	—
Money market funds	7,545	7,545	—	—
Total	\$9,933	\$8,987	\$946	\$—

The Company estimates fair value for its 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 September 30, 2016.

The Company's accounting policy is to recognize transfers between levels of the fair value hierarchy on the date of the event or change in circumstances that caused the transfer. There were no transfers between levels for the three and nine months ended September 30, 2016 and 2015.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

Investment securities: Long-term investments classified as available-for-sale are measured using quoted market prices when quoted market prices are available. If quoted market prices in active markets for identical assets are not available to determine fair value, then the Company uses quoted prices of similar instruments and other significant inputs derived from observable market data obtained from third-party data providers. Short-term investments are carried at amortized cost and the fair value is disclosed in Note 3. Fair value is determined in the same manner as available-for-sale securities and is considered a Level 2 measurement.

5. Debt

The Company has a revolving line of credit with a bank, which is secured by any and all interest the Company has in assets that are not otherwise restricted. The revolving line of credit bears a variable interest rate equal to the greater of 4.5%, or 1.25% plus the prime rate. Interest expense is due monthly on the outstanding principal amount with all amounts outstanding under the revolving line of credit due upon maturity in July 2018, or such extended maturity date if the revolving line of credit is automatically renewed. The revolving line of credit auto-renews annually unless canceled by the bank. The credit agreement requires the Company to comply with various financial and non-financial covenants. As of September 30, 2016, the Company was in compliance with all covenants. This facility also currently has a compensating balance requirement of \$0.5 million and an irrevocable standby letter of credit totaling \$1.1 million, which reduces the amount available on the line of credit. As of September 30, 2016, the Company had \$14.4 million available under its revolving line of credit.

Borrowings on the revolving line of credit are limited to the lesser of \$20.0 million in 2016 and 2015, and the total amount of cash and securities held by the Company's subsidiary, American Pet Insurance Company (APIC), less up to \$3.0 million for obligations the Company may have outstanding for other ancillary services in the future. As of September 30, 2016, the Company had \$4.0 million outstanding under this facility.

6. Commitments and Contingencies

During 2016, the Company entered into strategic marketing and service provider agreements, as well as other agreements with various parties. As of the September 30, 2016, these agreements resulted in an increase in future commitments from December 31, 2015 of \$0.8 million for the remainder of 2016, \$0.6 million in 2017 and \$0.3 million in 2018.

During 2016, the Company entered into a capital lease agreement. As of September 30, 2016, this agreement resulted in an increase in future commitments of \$0.1 million for the remainder of 2016, \$0.3 million in 2017 and \$0.2 million in 2018.

The outcomes of the Company's legal proceedings are inherently unpredictable, subject to significant uncertainties, and could be material to the Company's operating results and cash flows for a particular period. The Company makes a provision for a liability relating to legal matters when it is both probable that a liability beyond previously accrued amounts has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, estimated settlements, legal rulings, advice of legal counsel and other information and events pertaining to a particular matter.

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)
December 31, 2015	4,871,949	\$ 3.71	\$ 29,644
Granted	630,773	13.24	
Exercised	(894,572)	3.06	9,269
Forfeited	(253,656)	7.79	
September 30, 2016	4,354,494	4.99	51,855

Vested and exercisable at September 30, 2016 3,197,604 \$ 2.95 \$ 44,595

As of September 30, 2016, the stock options outstanding had a 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 statements of operations in claims expenses, other cost of revenue, sales and marketing, technology and development, and general and administrative expenses depending on the function performed by the employee or non-employee. The Company measures compensation expense on a

straight-line basis except for restricted stock with a performance condition which is measured on a graded vesting schedule. The remaining 350,631 shares of unvested restricted stock measured on a graded vesting schedule are expected to vest over the remaining service term of approximately 3.0 years.

As of September 30, 2016, the Company had unrecognized stock-based compensation expense of \$5.9 million, which is expected to vest over a weighted-average period of approximately 2.6 years. As of September 30, 2016, the Company had 1,122,183 unvested stock options and 355,329 restricted stock awards and units that are expected to vest. No net tax benefits related to the stock-based compensation costs have been recognized since the Company's inception. The expense recognized in each category is provided in the table below:

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	2016	2015	2016	2015
	(in thousands)			
Claims expenses	\$74	\$58	\$189	\$160
Other cost of revenue	9	10	26	35
Sales and marketing	172	102	419	342
Technology and development	67	97	158	311
General and administrative	454	482	1,423	1,501
Total stock-based compensation expense	\$776	\$749	\$2,215	