VETERINARY SERVICES FOR HOUSEHOLD PETS

Approach to profitability and financial analysis

01 November 2024

Competition & Markets Authority

Website: www.gov.uk/cma

Contents

Summary

1. As part of our market investigation into veterinary services in the UK, we are planning to carry out some financial analysis and, in particular, assess levels of profitability. This is a common feature of Competition and Markets Authority (CMA) market investigations and will form part of our overall assessment of whether there are competition problems, taken in conjunction with other evidence (for example on pricing, quality or new entry).

2. This analysis should enable us to assess whether the levels of profitability achieved by firms in the market are consistent with a competitive market or could be considered to be excessive. If excess profits have been present for a sustained period of time, this could indicate that competition is not working as well as it could be.

3. In order to conduct our profitability assessment, we have requested detailed financial information from the six large corporate groups (LCGs): CVS, IVC Evidensia (IVC), Linnaeus, Medivet, Pets at Home and VetPartners. In addition, we will assess internal documents from these groups, including those presenting rationale for acquisitions or reporting financial performance to senior management. We have also asked for financial information from a range of smaller vet businesses.

4. This paper sets out how we plan to analyse this information and seeks comments on our approach. It explains our proposed methodology, including the time period we plan to examine, what measures of profitability we intend to assess, and how we will examine the profitability of different providers of veterinary services.

5. We welcome comments from interested parties by **5pm on Friday 22 November 2024**.

1. Introduction and purpose of this paper

1.1 On 23 May 2024 the CMA, in exercise of its powers under sections 131 and 133 of the Enterprise Act 2002 (the Act), made a reference for a market investigation into the supply of veterinary services for household pets in the UK.

1.2 Shortly after the reference, on 9 July 2024, we published an issues statement, which set out initial theories on which features of the supply of veterinary services[1] for household pets might be adversely affecting competition, and the information we intended to gather to test our hypotheses.[2]

1.3 In the issues statement, we explained that profitability analysis would form part of our consideration of market outcomes.[3] We explained that we intended to carry out the following analysis:[4]

(a) For the large integrated veterinary groups, we would seek to establish the economic profits that have been made over time. This would involve estimating the return on invested capital and comparing it to an estimate of the weighted average cost of capital ('WACC').[5] The issues statement explained that our analysis of return on invested capital relative to WACC might be corroborated by analysis of margins over time.

(b) We would seek to carry out profitability analysis for a sample of smaller veterinary services businesses. The issues statement explained that this might be achieved through the use of publicly available accounting information and/or by sending requests for information to a sample of smaller veterinary services businesses.

(c) We would also seek to analyse the mark-ups applied to the most frequently sold medicines in order to understand the extent, if any, of any cross-subsidy between medicines and veterinary services.

1.4 The purpose of this paper is to set out the CMA's likely approach to financial and profitability analysis in more detail.

1.5 We have sent detailed financial information requests to the six LCGs. We also gave the LGCs the opportunity to make written submissions to us about the approach we might take or particular issues we should address. IVC did so, in a submission by Frontier Economics.

[1] Please see paragraph 3.4 for an explanation of what is included in veterinary services.
[2] CMA issues statement.
[3] CMA issues statement, paragraph 107.
[4] CMA issues statement, paragraph 107(a) to 107(c).
[5] We discuss how we propose to calculate WACC from paragraph 4.633.

1.6 We are currently working with a pilot group of approximately 20 independent vets and discussing with accountancy firms, and other advisory firms who specialise in veterinary practices, to understand what financial information is likely to be available and thus ascertain what financial analysis is likely to be feasible for the independently owned veterinary practices. Based on the results of this exercise we then will obtain financial information from a representative sample of approximately 50 independently owned veterinary practices.

1.7 We are currently reviewing the responses received to date, both from the LCGs and smaller veterinary businesses.

1.8 This document sets out the CMA's initial thoughts on a proposed methodology for our profitability analysis and has been produced prior to a complete review of the information provided in response to the aforementioned information requests. The methodology may therefore be updated and/or amended based on the data and information received. It should not, therefore, be assumed that we will always adopt the approach proposed in this document.

1.9 We welcome views on the proposed methodology set out in this paper. Specifically, we are seeking input on:

(a) The proposed approach to profitability analysis of the LCGs, including:

(i) our approach to assessing the profitability of the veterinary services operations of each LCG;

(ii) our approach to asset valuation;

(iii) our approach to estimating the WACC; and

(iv) our approach to analysing potential inefficiencies.

(b) The proposed approach to profitability analysis of the smaller providers of veterinary services.

1.10 We welcome views and comments on this paper by **5pm on Friday 22 November 2024**.

2. The role of profitability and financial analysis

2.1 The information obtained from our profitability analysis will be used across two main areas:

(a) *Diagnosis:* as part of our assessment of market outcomes (such as prices and profits) which can help us determine whether there are any adverse effects on competition (AECs); and

(b) *Detriment:* as part of our assessment of the degree and nature of any detrimental effect on consumers so far as it has resulted from, or may be expected to result from, any AECs.

2.2 The rest of this section explains each of these areas in more detail.

Diagnosis

2.3 When reaching a view concerning the functioning of a market, we consider the outcomes of the competitive process in that market, including, *inter alia*, the prices charged by firms and their profitability.[6]

2.4 The aim of profitability analysis is to understand competitive conditions within a market, by examining the outcomes of that market in terms of the financial performance of the participating firms. The Market Investigation Guidelines (the Guidelines)[7] state that:

> 'Firms in a competitive market would generally earn no more than a 'normal' rate of profit – the minimum level of profits required to keep the factors of production in their current use in the long run, ie the rate of return on capital employed for a particular business activity would be equal to the opportunity cost of capital for that activity.'[8]

2.5 The purpose of conducting profitability analysis, therefore, is to understand whether the levels of profitability (and therefore prices) achieved by the firms in the reference markets are consistent with levels we might expect in a competitive market. If excess profits (ie profits above the levels that we would expect in a competitive market) have been sustained over a sufficiently long period of time, this could indicate limitations in the competitive process.

2.6 On the other hand, the Guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may

[6] Competition Commission, Guidelines for market investigations: Their role, procedures, assessment and remedies (CC3 (Revised)) paragraph 103.
[7] CC3 (Revised).
[8] CC3 (Revised), paragraph 116.

be concealing ineffective competition. For example, incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.[9]

2.7 We shall interpret the results from our profitability assessment in the wider context of our market investigation, including our understanding of the broader competitive dynamics. In reaching a view about the functioning of the reference markets, and identifying any market features that may have an adverse effect on competition, profitability is one of the outcomes of the competitive process we may consider, alongside evidence on pricing and quality and/or innovation.

Detriment

2.8 Profitability analysis can also be used as an indicator of the degree and nature of customer detriment arising from any AECs.[10] Should we find profits to be above the 'normal level' (as defined above in paragraph 2.4), we plan to use our findings on the level of excess profits to inform our understanding of the extent of customer detriment.

2.9 We do not comment further on our empirical approach to estimating detriment using profitability analysis, as the assumptions and judgements used in the analyses for quantifying detriment will be the same as those used in the diagnosis phase.

[9] CC3 (Revised), paragraph 125.
[10] CC3 (Revised),paragraph 104.

3. Scope of our analysis

3.1 In this section we set out the proposed scope of our profitability assessment and the relationship with our terms of reference, highlighting which business activities we consider to be relevant, which firms we propose to analyse and the time periods over which we propose to assess profitability.

Business activities

3.2 For the purposes of this investigation:

(a) 'Household pets' means an animal such as a dog or a cat (but not a farm animal or horse) that is kept for companionship or protection and habitually resides in the owner's dwelling.

(b) The relevant consumer is a pet owner, rather than an 'animal owner' (which includes a broader range of species) or 'animal keeper' (someone who takes care of animals in a professional capacity).

3.3 We do not intend to consider specifically veterinary services which are aimed at farms, stables, or petting zoos. We intend to concentrate on the provision of vet services for pet owners who, in many cases, may be less experienced consumers of these services and less able to navigate the complexity of the market.

3.4 For the purposes of this reference, 'veterinary services' includes, but is not limited to, the provision of:[11]

(a) first opinion practice services;

(b) Out-of-hours first opinion services;

(c) diagnostic laboratory services;

(d) animal hospital services;

(e) referral centre services;

(f) pet cremation services;

(g) pet care plans; and

(h) prescribed veterinary medicines.

[11] Terms of Reference.

3.5 The scope of this reference therefore includes all the services which a first opinion vet practice (FOP), a referral centre, an out-of-hours (OOH) vet service, or an animal crematorium might supply to an owner of a household pet.

3.6 For the purposes of this investigation, the terms below have the following meanings:

(a) First opinion practice (FOP): the term used in this document, and in the sector, for general veterinary practices.

(b) Referral centre: a veterinary practice or animal hospital that offers services accessed via a referral from one qualified vet to another and where such referral work forms a substantial part of the site's offering (ie it has Veterinary Hospital accreditation by RCVS or equivalent). Vets at a referral centre may have a particular specialism, and referral centres may, for example, offer specialist imaging, dentistry or complicated surgery.

(c) Animal hospital: a veterinary practice that has Veterinary Hospital accreditation by RCVS or equivalent. Animal hospitals offer more specialist veterinary services and may also offer such general veterinary practice services alongside them.

(d) Diagnostic tests: any test with the aim of identifying a disease or condition or checking general indicators of overall health. This may include, but is not limited to, analysis of blood, tissue, urine or stool, as well as a range of scans and imaging tests.

(e) Pet care plans: paid plans that cover routine medication and services which may include annual vaccinations, check-ups, and preventative treatments against fleas and worms.

Identifying the relevant firms providing veterinary services

3.7 Our profitability assessment will focus on two groups of firms:

(a) The six LCGs: CVS, IVC, Linnaeus, Medivet, Pets at Home and VetPartners. In the UK, these firms have a combined share of FOPs of almost 60%.[12] We consider that these groups represent a substantial part of the supply of FOP services in the UK.

(b) A representative sample of the remaining 40% of independent FOPs, supplemented by four larger independent vet businesses with ten or more practices (which we call 'mid-tier' firms for the rest of this working paper).

[12] CMA issues statement, paragraph 29.

Time period under consideration

3.8 We aim to examine profitability over a time period that is sufficiently long to provide a representative picture of profitability and that is not unduly distorted by unusual macroeconomic conditions or one-off events. Our Guidelines recognise that the appropriate time period may vary depending on the specific market.[13]

3.9 Having discussed the availability of data with the LCGs, we obtained data over a three-year historical period in the first instance. Having reviewed this information and in view of the scope of our planned analysis (paragraphs 4.32 to 4.78), we propose to gather information for a further two years, covering a five year historical period in total (referred to as the Relevant Period in the rest of this working paper).

3.10 We note that the supply of veterinary services for household pets is generally considered resilient to economic downturns and unlikely to be materially affected by unusual macroeconomic conditions, with consumers continuing to spend on the welfare of their pets during periods of economic decline.[14]

3.11 Nonetheless, we note that the UK veterinary services market has undergone a period of recent disruption related to the Coronavirus (COVID-19) pandemic. In particular, we are aware that:

(a) Restrictions introduced in March 2020 limited the work of veterinary surgeons to maintaining the food supply chain and carrying out urgent and emergency veterinary work only in practices, leading to reduced revenues;[15]

(b) A significant increase in pet ownership during the COVID-19 pandemic has fuelled greater demand for veterinary care and a subsequent 'rebound' in revenues;[16]

3.12 We are also aware that the number of practicing vets and nurses has not kept pace with demand for services. The industry is highly dependent on EU veterinary surgeons and nurses and there has been a tightening of immigration policies since Brexit.[17] This may result in higher labour costs for businesses (as providers may rely on higher-cost locum services), or unusual staff utilisation rates, at least until there is some market adjustment to the available supply of veterinary professionals.

3.13 We shall interpret the results of our analysis in the context of these recent market events. In addition, to help guard against undue distortion caused by unusual or

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[13] CC3 (Revised), paragraph 121.
[14] See, for example, IVC Annual Report and Accounts for the year ended 30 September 2022, page 10. 'Veterinary care is an essential service, and the veterinary sector has remained resilient to previous periods of economic downturn'.
[15] RCVS/BVA joint statement, March 2020.
[16] IBISWorld Industry Report: Veterinary Services in the UK, November 2023, page 20. M75.000 Veterinary Services in the UK Industry Report November 2023.pdf
[17] IBISWorld Industry Report: Veterinary Services in the UK, November 2023, page 24.

one-off events, we intend to gather forecast data to supplement our analysis of historic financial performance.

4. Proposed approach to profitability analysis

Overarching conceptual approach

Return on capital employed versus cost of capital

4.1 As stated above, the analysis of profitability as a means of understanding competitive conditions in a market is based on the premise that firms in a competitive market would generally earn no more than a ‘normal’ rate of profit.[18]

4.2 The opportunity cost of capital is the (weighted average) return on capital,[19] ie the return which investors expect for providing capital to firms undertaking the in-scope activities. This can be thought of as a market-based return on investment, to compensate investors for providing money to firms in the market.

4.3 The rationale for benchmarking return on capital with the opportunity cost of capital is that, in a competitive market, if firms persistently earned in excess of the return required to compensate investors for the risks taken, we would expect entry and/or expansion. This entry/expansion would serve to compete away profits[20] in excess of the cost of capital, up until the point where efficient firms on average cover their total costs, including a market-based cost of capital and no more. Where firms persistently earn in excess of a normal return, this signals that there may be limitations in the competitive process.

4.4 Our Guidelines, therefore, refer to the rate of return on capital as a means of measuring profitability. Return on capital can be based on profits (return on capital employed (ROCE)) or cash flows (internal rate of return (IRR)). The appropriateness of a given measure will depend on the nature of the industry and the pattern of investment.[21] Ordinarily, where data permits, we use ROCE, as this can be computed annually and thus provides greater insights into trends over time and the drivers of profits above the ‘normal’ level.

4.5 Figure 1 below illustrates how ROCE is calculated.

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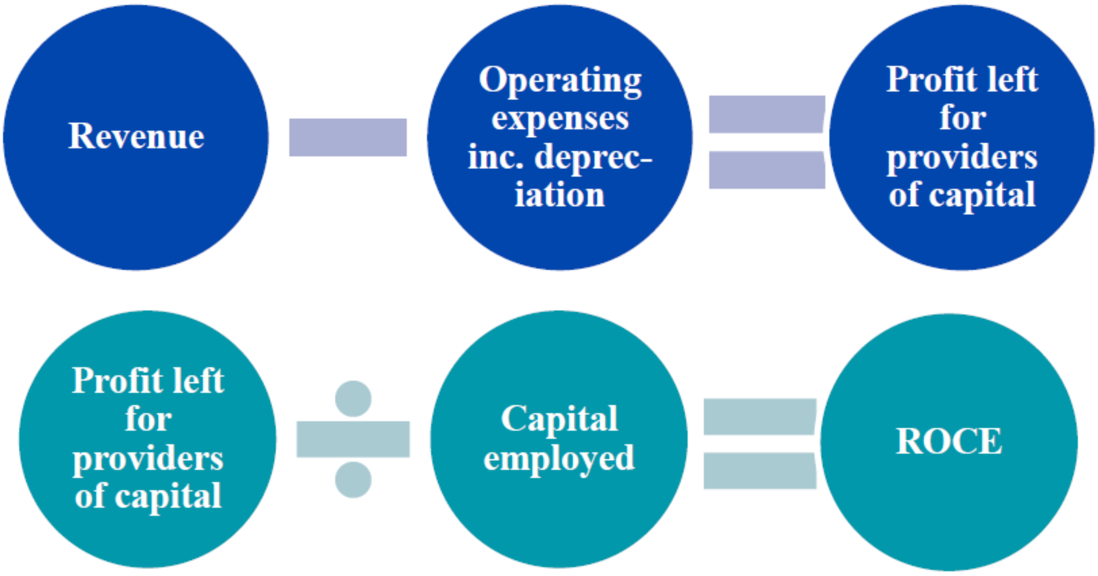
[18] CC3 (Revised), paragraph 116.
[19] Specifically, the mean ex ante expected return on capital of debt and equity holders, weighted by gearing.
[20] The time period over which this process may take place may differ between different sectors due to the time taken for entry and/or expansion of capacity.
[21] CC3 (Revised), Annex A, paragraph 10.

Figure 1: The components of ROCE



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

4.6 The ROCE is then benchmarked against the WACC over the Relevant Period. The WACC is the return on investment that providers of capital – both debt and equity – expect, given the risks associated with the relevant activity.[22]

4.7 In practice, we might expect the profitability of some firms to exceed a 'normal' level from time to time.[23] However, a situation where the ROCE of firms representing a substantial part of the market has exceeded the WACC over a sustained period could be an indication of limitations in the competitive process.[24]

4.8 However, we note the following considerations when applying the ROCE versus WACC framework:

(a) ROCE percentages can sometimes be distorted, for example where firms choose to lease a material portion of their assets, and these leases are classified as operating leases for the purposes of financial reporting, or where investment in intangibles[25] is expensed, rather than capitalised.

(b) ROCE percentages can sometimes be distorted by the choice of accounting depreciation method.

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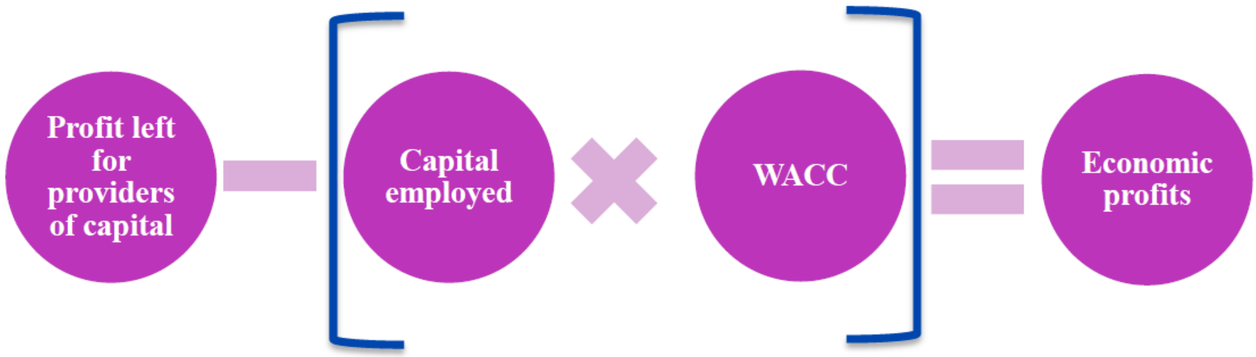
[22] WACC is therefore expected return on equity and expected return on debt, weighted by gearing (the relative proportions of debt and equity).
[23] CC3 (Revised), paragraph 117.
[24] CC3 (Revised), paragraph 118.
[25] Assuming the expense is capital in nature, rather than simply an ongoing cost of running the business.

(c) The scale of any excess profits, and therefore detriment in monetary terms, is not immediately clear from a percentage gap between ROCE and WACC.

4.9 We deal with the first two issues at paragraphs 4.45 and 4.48. The third issue can be alleviated by calculating economic profits in absolute terms. We therefore propose to calculate economic profits as well as ROCE. Economic profits are the profits left over, after the providers of capital have been paid a market-based return on their investment, which is equal to the capital employed multiplied by the WACC. Given that economic profits are revenues less total operating costs, including a market-based cost of capital, they can be calculated using the same input data and analysis as ROCE versus WACC.

4.10 Figure 2 shows how economic profits are calculated.

Figure 2: Economic profits



Source: CMA analysis. Note, profit left for providers of capital can be distributed or reinvested in the business.

4.11 We recognise that economic profitability analysis based on a ROCE versus WACC framework requires a number of assumptions to be made. The results from economic profitability analysis can be sensitive to ranges around these assumptions, particularly with regard to asset valuations. We therefore propose to supplement our ROCE analysis with additional analysis, such as margin benchmarking, as a sense check on our findings. More details of this 'additional analysis' are set out from paragraph 4.98.

Scope of relevant operating revenues, costs, assets and liabilities

4.12 We determine the ROCE using operating profits and net operating capital employed and then compare it to the relevant pre-tax WACC. The general principle is that all revenues, costs, assets and liabilities necessarily arising from the operation of the business to supply the in-scope activities should be included.

4.13 In practice this means that the following should be excluded:

(a) Financing costs both of a profit and loss and balance sheet nature, eg interest and sources of finance regardless of whether they are short- or long-term.

(b) Corporation taxation on income and any associated balance sheet assets and liabilities.

4.14 It is our usual practice to measure profitability on an operating basis, thereby excluding the impact of interest and tax. This means that profitability can be assessed independently of the choice of capital structure of individual firms.

4.15 We are seeking to assess profitability at two levels: at the level of the relevant segments of the LCGs (eg FOPs, Referral Centres etc), and at the level of the LCGs' UK-wide veterinary service activities.

Economic versus accounting profitability

4.16 When estimating ROCE, our approach is to start with accounting figures from the profit and loss accounts and balance sheets of the operating units of the firms which undertook the relevant activities, and then make adjustments to arrive at an economically meaningful measure of profitability.

4.17 Deriving an economically meaningful measure of profitability from accounting data, in practice, usually requires adjustments to the following areas:

(a) **Identification and valuation of capital employed in the business***:* As set out in Figures 1 and 2 above, an assessment of economic profitability requires an estimate of the capital employed in the business. Capital employed is measured by valuing the assets needed to provide the in-scope activities.[26] When undertaking profitability analysis, the assets should, in theory, be valued according to the current opportunity cost of owning the asset or the value to the business (VTB).[27] This usually requires an adjustment to one or more balance sheet values, as explained from paragraph 4.18.

(b) **Adjustments to reflect the stand-alone profitability of the relevant activities**: There are four typical steps to achieving this:

(i) Separating out the assets, liabilities and transactions that are wholly attributable to the relevant activities, on a cost-causal basis.

[26] More specifically, the net operating assets.
[27] Also referred to as the deprival value, or value to the owner principle.

(ii) Allocating common costs, joint costs and common assets to the relevant activities.

(iii) Identifying services within the relevant activities that flow between the same corporate group. Any internal transfer prices should be adjusted to reflect the arm's-length value of the related products or services.

(iv) Identifying any additional costs, assets or liabilities that would be incurred in carrying out the relevant activities on a stand-alone basis.

Our approach to asset valuation

4.18 The assets included in the capital employed element of the profitability analysis should reflect their value to the business. The VTB approach aims to value assets in such a way that our analysis of asset valuation, when assessing economic profitability, allows for:

(a) existing firms in the market to recover the opportunity cost of using the assets to supply the in-scope activities; and

(b) a hypothetical entrant to recover the costs of the assets required to supply the relevant activities.[28]

4.19 Accounting values of assets may not reflect the VTB. This may be because:

(a) for reasons of accounting prudence,[29] an asset is not on the balance sheet;

(b) the firm has depreciated most if not all of the cost of the asset and the asset is expected to provide service into the future, eg diagnostic equipment at zero book value;

(c) changes in technology over time may mean that asset carrying values in the Relevant Period differ to the balance sheet values; and/or

(d) the values given to certain assets, in particular those recognised on acquisition of another firm, may be based on the level of economic profits expected to be derived from the use of that asset, making asset valuation a circular exercise, and thus not informative for the purposes of our assessment.

[28] Where the assets yield equivalent services to those currently used by the existing firm(s) being analysed.
[29] Prudence is defined as 'The exercise of caution when making judgements under conditions of uncertainty. This means that assets and income are not overstated and liabilities and expenses are not understated. Equally, the exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses.' Source: Conceptual Framework for Financial Reporting, International Accounting Standards Board, March 2018, page 83.

4.20 The VTB of an asset can be determined by reference to entry value (replacement cost), exit value (net realisable value) or value in use (discounted present value of the cash flows expected from continuing use and ultimate sale by the present owner). For some assets (for example, investments in actively traded securities), these three alternative measures produce very similar amounts, with only small differences due to transaction costs. However, for other assets (for example, fixed assets specific to the business), differences between the alternative measures can be material.

4.21 In most cases, as the entity will be putting the asset to profitable use within its current operations, the asset's value in its most profitable use (in other words, its recoverable amount) will exceed its replacement cost. In such circumstances, the entity will, if deprived of the asset, replace it, and the current value of the asset will be its replacement cost.

4.22 Where an asset is worth replacing, its VTB will be its current replacement cost or, more precisely, the replacement cost of a Modern Equivalent Asset (MEA)[30] determined in a fully competitive market and allowing for the asset's remaining useful life.[31] The MEA value is the cost of replacing an old asset with a new one with the same service capability.

4.23 A valuation based on replacement cost of MEA value is the most common outcome of a VTB assessment. This approach is consistent with our Guidelines, which state that the CMA considers MEA values to be the most economically meaningful measure for the purpose of measuring profitability in most cases.[32]

4.24 However, in some circumstances, the recoverable amount may be lower than the replacement cost. An asset will not be replaced if the cost of replacing it exceeds its recoverable amount. In such circumstances, the asset's current value is determined as follows:

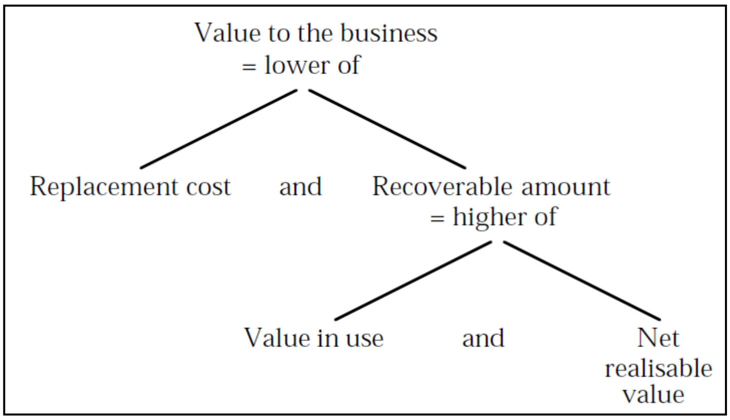
(a) When the most profitable use of an asset is to sell it, the asset's recoverable amount will be the amount that can be obtained by selling it, net of expenses; in other words, its net realisable value (NRV).

(b) When the most profitable use of an asset is to consume it – for example, by continuing to operate it – its recoverable amount will be the net present value (NPV) of the future cash flows; in other words, its value in use.

4.25 This can be portrayed diagrammatically as shown in Figure 3 below.

[30] The MEA value is the current cost of acquiring assets that yield equivalent services to those currently used by the firm, based on the most efficient technology and optimal configuration.
[31] Otherwise known as depreciated replacement cost.
[32] CC3 (Revised), Annex A, paragraph 14.

Figure 3: Hierarchy of valuation bases for value to the business (VTB)



Source: Statement-of-Principles-for-Financial-Reporting (ASB) (1999), Chapter 6 Measurement in Financial statements, Alternative measures of current value, paragraph 6.8.

4.26 Application of these valuation principles consistently across all assets and liabilities is called current cost accounting (CCA).

Reflecting the in-scope activities on a stand-alone basis

4.27 We are interested in the profitability of the business activities which are in scope, which in this case is the provision of first opinion veterinary services, OOH first opinion services, diagnostic laboratory services, animal hospital services, referral centre services, pet cremation services, pet care plans, and prescribed veterinary medicines.

4.28 Where a particular business activity is being analysed and is only one part of the firms' activities – for example, for IVC which provides referral centres and has online pharmacies, pet crematoria, and an OOH business – the financial information needs to be prepared as if these activities had been undertaken by the firm on a stand-alone basis. This will require allocation of revenues, common costs, joint costs, assets and liabilities, which should, as far as possible, be done on a cost-causal basis.

Materiality and lack of unnecessary complexity

Materiality

4.29 We intend to make adjustments to financial information supplied to us where it is likely to make a material difference to our assessments. An item of information is material if its misstatement or omission might reasonably be expected to influence the economic decisions of users (in this instance, the CMA) of that information. Whether information is material will depend on the size and nature of the item in question judged in the particular circumstances of the case. The factors to be taken into account are set out below. It will usually be a combination of those factors, rather than any one in particular, that will determine materiality:

(a) We judge the item's size in the context both of the financial information as a whole and of the other information available to us that would affect our evaluation of that financial information. This includes, for example, considering how the item affects the evaluation of trends and similar considerations;

(b) We consider the item's nature in relation, for example, to the transactions or other events giving rise to it.

4.30 If there are two or more similar items, the materiality of the items in aggregate as well as of the items individually needs to be considered.

Lack of unnecessary complexity

4.31 We also place value on the simplicity (but not at the expense of materiality) of the financial information used in our assessment. What we mean by this is that, rather than seeking to make elaborate numerical adjustments (for example in relation to the age profile of surgical equipment) or numerical adjustments involving a high degree of professional judgement (for example efficiency adjustments), we plan to incorporate such aspects, important though they may be, qualitatively into our assessment and interpretation of the firms' profitability.

Approach to profitability analysis for the large corporate groups

4.32 As set out at paragraph 3.7, we propose to undertake profitability analysis for the six LCGs: CVS, IVC, Linnaeus, Medivet, Pets at Home and VetPartners.

4.33 This section proceeds as follows:

(a) First, we explain our approach to assessing the in-scope activities.

(b) Second, we set out our approach to asset valuation.

(c) Third, we set out our approach to calculating the WACC.

(d) Fourth, we set out our approach to assessing potential inefficiencies.

Assessing the in-scope activities

4.34 All of the LCGs provide a range of veterinary and related services for household pets. Table 1 summarises the services provided by each LCG.

Table 1: The large vet groups' related businesses and services

	IVC	*CVS*	*VetPartners*	*Linnaeus*	*Medivet*	*Pets at Home*
FOPs	✓	✓	✓	✓	✓	✓
RCVS-specialist led referral centres	✓	✓	✓	✓	✓	
Operationally separate OOH businesses*	✓					
Diagnostic laboratories		✓	✓	✓	✓	
Crematoria	✓	✓	✓			
Online retail pharmacy	✓	✓	✓			
Medicines buying group		✓				

*Note: * all FOPs are required to make provision for OOH services for their patients. Most of these services will be provided by FOPs.*

4.35 For the purposes of our profitability analysis, we have explored the available financial information with the LCGs and considered whether it would be practicable to:

(a) obtain financial information related to services for household pets only (ie excluding services provided to farm and equine animals); and

(b) obtain sufficient information to conduct separate economic profitability analysis for each of the following in-scope services (adopting the approach described in paragraph 4.17(b)):

(i) FOP services;

(ii) OOH first opinion services;

(iii) diagnostic laboratory services;

(iv) animal hospital services;

(v) referral centre services;

(vi) pet cremation services;

(vii) pet care plans; and

(viii) prescribed veterinary medicines.

4.36 As regards 4.35(a), we observe that some firms are able to provide this information more easily than others:

(a) CVS provided detailed profit and loss information for 'small animal sites' but told us that the balance sheet for its UK Veterinary Practice Division – which comprises small animal, farm, equine, referral practices, wholesale consumables, buying groups and white label medicines and products – could not easily be split out to small animal only.[33]

(b) IVC told us that its UK Vets business segment included small animal, mixed, farm and equine FOPs (as well as IVC referral centres and IVC's retail online pharmacy, Pet Drugs Online).[34] It told us that separating UK Vets to small animal services only would be extremely time consuming, particularly for balance sheet information.[35] IVC told us that small animal services represented 'the vast majority of UK Vets' and accounted for approximately [✂] of UK Vets revenue.[36]

(c) Linnaeus told us that it did not segment reporting on the basis of type of animal handled (ie it did not report revenue against small animal, mixed, farm and equine). It told us that a small number of its brands incorporated a combination of small animal/farm and/or small animal/equine, but that none of its brands focused solely on farm/equine and these services were offered alongside small animal services.[37]

(d) Pets at Home was able to provide financial information relating to small animal services only,[38] as this is the focus of its vet group.[39]

(e) VetPartners provided financial information relating to its business but told us that it had been required to make a number of assumptions in order to present revenues and costs in the way requested by the CMA and that this exercise could not be exact.[40]

4.37 As regards paragraph 4.35, we have found that the LCGs do not segment their businesses between the activities in which we are interested. In particular, we note that there is no clear delineation between FOP services and referral services, and that OOH services are not generally structurally separate from the regular operations of a site:

(a) CVS told us that it records balance sheet information for the UK Veterinary Practice Division (which, as above, comprises small animal, farm, equine, referral practices, wholesale consumables, buying groups and white label medicines and products), the Laboratories Division, the Crematoria Division

[33] CVS response to RFI6, paragraph 35.
[34] IVC response to RFI6, paragraph 4.3.
[35] Email from IVC to the CMA dated 2 September 2024.
[36] Email from IVC to the CMA dated 2 September 2024.
[37] Linnaeus response to RFI6, page 3.
[38] Pets at Home response to RFI6, financial template submission.
[39] Pets at Home response to RFI1, paragraph 2.3.
[40] VetPartners response to RFI6, page 2.

and Online Retail. It told us that it 'does not have detailed balance sheets for Local Clinics, Referral Centres, Standalone OOH or wholesale medicines'.[41]

(b) IVC told us that there is a range of models for offering referral services and that these services are offered at many FOPs.[42] It told us that it could provide financial information for its UK Vets business segment but noted this aggregated FOPs, referrals and its online pharmacy.[43] It told us that it was 'not possible' to break the UK Vets balance sheet into further categories, for example referrals, because significant elements of the balance sheet could not be allocated to [✂].[44]

(c) Linnaeus told us that it assigned its brands to one of two categories for reporting purposes: 'Primary Care' and 'Referral'. It told us that some brands may provide both FOP and referral services, but that their results would be reported under only one of 'Primary Care' or 'Referral'.[45]

(d) VetPartners told us that it did not segment its business between FOPs, referrals, OOH and other services, and that there existed no clear delineation between FOP and referral work.[46]

4.38 Given:

(a) the ways the LCGs have told us they segment their businesses and record balance sheet information;

(b) that in some cases it is not possible to separate each of the in-scope activities of each LCG (on the basis described in paragraph 4.17(b)); and

(c) the considerable complexity involved in reliably separating such activities even in cases where it may be possible,

(d) we propose to assess the profitability of the veterinary services operations of each LCG, without seeking to (i) exclude revenues and costs from farm/equine services, or (ii) assess separately the economic profitability of the different types of veterinary services.[47]

4.39 This approach reflects the basis on which the LCGs assess their own performance and how they are organised operationally. It also avoids the potentially arbitrary allocation of costs and capital between the various services of the LCGs, which are generated using the same asset base. We propose to take into account the

[41] CVS response to RFI6, paragraph 35.
[42] Email from IVC to the CMA dated 2 September 2024.
[43] IVC response to RFI6, paragraph 4.3.
[44] IVC response to RFI6, paragraph 4.14.
[45] Linnaeus response to RFI6, page 3.
[46] VetPartners response to RFI6, paragraph 4.3.
[47] We are able to exclude the retail operations of Pets at Home as this is structurally separate from the veterinary services operations.

potential impact of out-of-scope activities in our interpretation of our profitability analysis.

4.40 Where necessary to consider certain of our theories of harm and, if those are made out, the possible remedies, we also propose to supplement our profitability analysis of each LCG with margin analysis of the different types of veterinary services,[48] with margin analysis by FOP veterinary site or practice, and likewise, with an assessment of documentary evidence relating, for example, to firms' acquisition and business strategies. This would enable us to consider, for example, whether the vertical integration of firms is having, or contributes to, an adverse effect on competition and the ways that effect might be remedied, whether by divestment or other remedies.

4.41 We have also requested that the LCGs provide: (i) the cost of purchasing pharmaceuticals/medicines/drugs and other consumables before the application of rebates, and (ii) the associated discount and rebate amounts. We intend to use this information to understand the effect of discounts and rebates on the profitability of medicines sold by the LCGs through their FOPs and, where applicable, through their online pharmacies and buying groups.

Approach to asset valuation

Tangible fixed assets

4.42 For the provision of veterinary services for household pets, we understand the main tangible fixed assets required are buildings (ie veterinary sites), fixtures and fittings, and medical equipment used to provide veterinary care.

4.43 We sought information from the parties to understand to what extent the net book value (NBV) on the balance sheet is a good approximation for the MEA value of tangible fixed assets and, to the extent it was not a good approximation, we sought information from the parties on replacement cost and recoverable amount.

(a) Medivet told us[49] that it believed NBV was not a good approximation for the cost of replacing the assets. This was for a number of reasons, largely due to [✂], and to the need to make property improvements and replace equipment with new items when needed.

(b) IVC told us[50] that NBV provided a poor approximation for the replacement cost of assets, due to two overarching issues:

[48] For FOPs, we note that this may include FOP veterinary services for mixed and farm/equine in addition to small animal/household pets.
[49] Medivet response to RFI7 Q1.
[50] IVC response to RFI7 Q1 and CMA Vets MI: Economic Profitability Analysis, October 2024, produced by Frontier Economics on behalf of IVC, slide 13.

(i) [✂] of IVC's assets were missing from the asset register, as a result of the company growing through acquisition [✂];

(ii) the NBV for assets that were recorded was lower than the replacement cost, because [✂] assets were used for longer than their accounting life, with the result that [✂] assets which were still in use were considered fully depreciated and had a NBV of zero.

(c) IVC also told us[51] that there was no liquid and comprehensive second-hand market for veterinary services equipment.

(d) VetPartners told us[52] that NBV of the assets used to provide veterinary services was not a good approximation of the cost of replacing assets, for the following reasons:

(i) NBV is simply the historic cost of an asset less the accumulated depreciation and was not intended to reflect the current replacement cost of the assets employed within the business; NBV would typically be expected to be significantly lower than the replacement cost;

(ii) NBV did not account for current market prices or demand for similar assets; the cost of replacing equipment had increased considerably in the last few years, while the NBV would not account for those movements in market prices;

(iii) there was no active and sufficient second-hand market for equipment, and as a result VetPartners normally bought new equipment in order to replace equipment; it would be impossible to replace the assets of a practice with an equivalent portfolio of assets in the second-hand market;

(iv) insurance policies in the sector tended to be on a 'new for old' basis, which evidenced the fact that there was no active second-hand market for insurance;

(v) because veterinary practices required a significant amount of construction to be fit for purpose, and given that there was no ready supply of buildings tailored to veterinary practice use, replacing a practice would generally mean that VetPartners must find a suitable building, obtain permission for change of use and seek planning consent to make alterations to fit it out as a veterinary practice; construction costs had increased significantly in the last few years which meant that the cost to buy or lease property and subsequently

[51] IVC response to RFI7 Q1.
[52] VetPartners response to RFI7 Q1.

adapt it into a veterinary practice would be significantly higher than a few years ago and also significantly higher than the NBV;

(vi) [✂]

(vii) the economic life of the assets on the balance sheet was generally significantly longer than the accounting life, resulting in a number of assets having a low or even zero NBV, even though the assets still had a long economic life left and were in use by the business.

4.44 In the following paragraphs, we set out our proposed approach to the recognition of leased and freehold properties.

Leased properties

4.45 We also note that all of the LCGs lease a portion or all of their property assets. Where assets are accounted for as operating leases,[53] the value of those assets would not be included in the balance sheet information which we have requested from the parties. This means that the initial provision of accounting information relating to their capital employed would be lower than if the leased assets were held on the balance sheet. In addition, earnings before interest and tax (EBIT) might be lower due to rental payments being greater than the associated depreciation for the right of use asset. We propose making an adjustment in respect of operating leases in order to include them in the capital base, to avoid the distortive effect on ROCE. We will consider submissions on our proposal to capitalise leased assets, and plan to gather further information from the LCGs to make any necessary adjustments.

Freehold properties

4.46 In respect of freehold properties, we note that where assets are long-lived and have been recorded at historical cost in the accounts, the carrying value is unlikely to reflect MEA value, and therefore the most valid approach will be to revalue freehold properties. We welcome views on:

(a) the likely necessity/materiality of making revaluation adjustments for freehold property; and

(b) if required, on the appropriate approach to revaluation.

[53] It is currently the situation that leases that would under IFRS (International Accounting Reporting Standards) be capitalised as 'right of use' assets are accounted for as operating leases under UK GAAP (Generally Accepted Accounting Practice) ie no asset is recognised and instead 'rental payments' are expensed to the profit and loss account. LCGs across their corporate groups report both under UK GAAP (eg for entity accounts for individual veterinary practices they have set up or acquired) and IFRS (for their group financial statements).

Fixtures and fittings, and equipment

4.47 Since the parties told us that the NBV was not a good approximation for MEA value, we will be seeking further information from the parties on replacement cost and recoverable amount and will consider the most appropriate approach. We welcome views on:

(a) The extent to which insurance values, and re-build estimates, are an appropriate method of valuation.

(b) Other appropriate methods of valuation we should consider.

(c) The extent to which there is a second-hand market for veterinary services equipment.

(d) The extent to which an adjustment for any missing assets will make a material difference to our assessment, and if so, any approach for identifying and valuing those assets.

4.48 Depreciation, where relevant, will follow a straight line approach in the first instance, unless it becomes apparent that economic or annuity depreciation would yield materially different results.[54]

Intangible assets

4.49 In addition to the tangible assets used to provide veterinary services, we shall consider whether certain intangible assets should be included in capital employed. We note that the LCGs include very high amounts for intangible assets on their balance sheets; these intangible assets include goodwill, software, and brand and reputation assets such as customer relationships, know-how and trade names. In response to the issues statement, we note that one LCG (IVC) told us that there are important intangible assets (including goodwill) which should be appropriately valued as part of any economic profitability analysis.[55]

4.50 Our Guidelines set the criteria for considering whether to recognise an intangible asset for the purposes of economic profitability analysis. The Guidelines state that we may consider the inclusion of certain intangible assets where the following criteria are met:

(a) it must comprise a cost that has been incurred primarily to obtain earnings in the future;

[54] This is the case where asset replacement patterns are lumpy and infrequent.
[55] IVC Response to the issues statement, 30 July 2024, paragraph 9.6(ii)

(b) this cost must be additional to costs necessarily incurred at the time in running the business; and

(c) it must be identifiable in creating an asset separate from any assets arising from the general running of the business.[56]

4.51 IVC told us[57] that intangible assets within the veterinary sector are substantial, and a key reason for the LCGs' acquisition-based growth strategy. It listed customer relationships, vet practice reputation and brands, and intellectual capital as the three categories of intangible asset. It also told us[58] that it had acquired [✂] intangible assets via acquisition rather than organically, and although it currently had around £200 million in intangible assets (customer lists, brand) on the balance sheet of UK Vets based on accounting standards, there was a further c. £1 billion under accounting goodwill, which it said in part would reflect the value of intangible assets acquired, but that the true economic value of these intangible assets was not fully reflected under standard accounting practice.

4.52 In the following paragraphs, we set out our proposed approach to the recognition of goodwill and other intangible assets. We discuss software/IT intangibles first, then goodwill, and brand and reputation assets.

IT systems and software development costs

4.53 Some of the LCGs have invested in bespoke practice management systems and software in order to help them manage their businesses and their interactions with their customers. Firms routinely capitalise, and depreciate, this type of expenditure. We understand that there are also specialist veterinary software providers who provide their product on a subscription basis.

4.54 We accept that the costs of acquiring and/or developing such systems meet our criteria for the recognition of an intangible asset in that they represent an investment in the business incurred primarily to obtain earnings in the future, and such costs are additional to those necessarily incurred at the time in running the business. We will consider whether they create an asset that is separable from any arising from the general running of the business. If we decide that this is a reasonable assumption to make, we will include the costs of acquiring and/or developing such assets at their cost, and depreciate those assets over an appropriate period. We will consider submissions and plan to gather further

[56] CC3 (Revised), Annex A, paragraph 14.
[57] CMA Vets MI: Economic Profitability Analysis, October 2024, produced by Frontier Economics on behalf of IVC, slide 31
[58] CMA Vets MI: Economic Profitability Analysis, October 2024, produced by Frontier Economics on behalf of IVC, slide 37

information from the LCGs in order to inform our understanding of the software costs necessary to provide veterinary services.

Goodwill

4.55 Purchased goodwill is not a separately identified asset but rather is a balancing figure put within consolidated financial statements. It is the remaining, unallocated element of an acquisition price once all tangible assets and certain (although not necessarily all) intangible assets have been fair-valued and set against the price paid. In principle, we agree that, when purchasing a business, an element of the goodwill may represent the value of intangible assets not capitalised on a business's balance sheet.

4.56 The approach that we propose to take is to recognise those intangible assets that meet our criteria for recognition, at their value to the business. This will include internally generated assets, as well as those separately identified in acquiring businesses' balance sheets or included within a balancing goodwill figure, but will exclude any remaining goodwill. This approach ensures that only intangible assets that meet our criteria for recognition are included in the estimate of capital employed by the relevant firms, and also avoids the risk of capitalising any 'excess profits' that the business is able to generate, which may be reflected in the purchase price and hence the purchased goodwill.

Brand and reputation assets

4.57 These intangible assets might comprise customer lists (including patient data records), trade names, and know-how.

4.58 We recognise that the reputation of a veterinary business, either in a LCG or single practice site, may be developed over time by providing high-quality advice and treatment. We also recognise that some of the LCGs may have avoided incurring higher customer acquisition costs under the organic growth model (for example marketing costs and one or more years of losses during the start-up phase of a veterinary practice), by growing customer volumes by acquisition.

4.59 We consider that when practices either acquire trade names by buying other firms or develop their own trade name, brand or reputation organically, they are incurring costs with the aim of generating earnings in the future. We also consider that many such costs are likely to be additional to the costs incurred in running the business. Such expenditure therefore meets two of three of the CMA's criteria for recognition of intangible assets. With respect to the third criterion (that the asset be separable from those assets arising from the general running of the business), this may depend on the particular circumstances of the acquisition. We understand that in the vast majority of acquisitions, a trade name or brand would have been purchased alongside the underlying veterinary practice.[59] Therefore it is unlikely that trade names/reputation assets would meet our criteria for recognition in themselves.

4.60 However, we appreciate that looking at the expenditure of marketing costs and/or start-up losses in a situation of organic growth might be a reasonable way to encapsulate a brand and/or reputation asset value, using a cost-based approach. In this context we would only include those costs which are additional to those incurred in running the business.

4.61 There are two approaches which we are currently considering, in order to estimate the replacement cost of firms' brands and/or reputations: marketing costs, as a proxy for the value of a firm's customer relationships, and start-up losses, as a proxy for the investment required to build the necessary intangible assets in the start-up period.

4.62 We will consider submissions and plan to gather further information from the LCGs in order to inform our understanding of the intangible assets necessary to provide veterinary services.

Approach to calculating WACC

4.63 We explained in paragraphs 4.1 to 4.4 that our ROCE estimates will be benchmarked against the WACC.

4.64 The WACC is the weighted average return which debt and equity investors expect for providing capital to firms for undertaking the in-scope activities, weighted by the gearing.[60]

4.65 We propose to estimate a market-based WACC, for a notional stand-alone provider of veterinary services for household pets. We will consider whether it is appropriate to use a single estimate for the Relevant Period or calculate an annual WACC estimate. The WACC will be compared to the ROCE calculated for each of the LCGs. We will also consider whether an adjusted WACC should be calculated for profitability analysis of independent veterinary practices.

4.66 We propose to undertake two pieces of work to inform our WACC estimate.

(a) Firstly, we propose to estimate our own WACC for a notional provider.

(b) Secondly, we shall consider the internal WACC estimates used by the LCGs in their internal investment decisions and information from analyst reports

[59] We are aware of Medivet's two purchases of customer relationships in 2021 and 2022, as set out on page 65 of Hecate Holdco Limited's Annual report and financial statements for the year ended on April 2023, but no other acquisitions where the underlying business and assets was not purchased alongside the customer lists.
[60] Gearing is the relative proportion of debt and equity.

during the Relevant Period. These estimates will be used as a cross check to our WACC estimate.

Estimate of WACC

4.67 The WACC must reflect the effects of tax on returns to capital providers. As set out in paragraph 4.12, we intend to measure profitability on an operating basis, thereby excluding the impact of interest and tax.[61]

Cost of equity

4.68 Consistent with the CMA Guidelines,[62] we will use the Capital Asset Pricing Model (CAPM) to calculate the cost of capital, since this is a widely understood technique with strong theoretical foundations.[63]

4.69 The CAPM is a one-factor model, with the beta – which measures the way returns on investment in a specific stock varies with returns on the market as whole[64] – being the only specific factor that needs to be estimated.[65] We propose to estimate the beta using the two listed LCGs, CVS and Pets at Home.[66] We will also explore the possibility of using listed international firms in the same sector.[67]

4.70 We shall consider whether adjusting the average beta is appropriate, given the systematic risk profile of the in-scope activities compared with the comparator data set. For example, CVS's beta will reflect the risks faced by a listed provider of veterinary services. Pets at Home's beta will reflect the risks faced by a listed retailer and to a lesser extent that of a provider of veterinary services. To the extent that investors are exposed to different levels of systematic risk when investing in these different types of services, an adjustment may be required.

4.71 We will review whether the listed LCGs have excess cash balances and how these should be treated in the beta calculation.

[61] As a result, we will assess profitability independently of the choice of capital structure of individual firms. The returns to equity holders (dividends) are taxed. Hence, where the cost of equity is expressed 'pre-tax', the cost of equity used must reflect the fact that the actual return to shareholders will be reduced by the rate of tax. We therefore intend to estimate the cost of capital on a nominal pre-tax basis to ensure consistency when comparing profitability with the cost of capital.
[62] CC3 (Revised), Annex A, paragraph 16.
[63] CC3 (Revised), paragraph 116.
[64] Specifically, the formula for beta is the covariance of the returns on the specific stock with returns on the market index divided by the variance of returns on the market index.
[65] Market-wide parameters – being the risk-free rate and equity risk premium, will be estimated using market data and follow regulatory precedent in this area, to the extent that the precedent remains relevant/valid.
[66] Both CVS and Pets at Home are listed on the London Stock Exchange. CVS is listed on the Alternative Investment Market (AIM) and Pets at Home is listed on the main market. While both are in the 'consumer discretionary' industry within the Industry Classification Benchmark (ICB), Pets at Home's ICB subsector is 'speciality retailers,' and CVS' is 'consumer services/misc.'
[67] With due allowance for differences in gearing levels between the comparators.

Cost of debt

4.72 We will review the actual cost of debt of the LCGs and also consider relevant debt indices when calculating the cost of debt. We plan to include lease liabilities associated with right of use assets (as discussed in paragraph 4.45) when calculating the cost of debt.

Gearing

4.73 Gearing will be set based on the gearing of the comparator set of firms, described at paragraph 4.70 above. As noted in paragraph 4.72 we will include lease liabilities associated with right of use assets when calculating gearing.

Assessment of potential inefficiencies

4.74 Our Guidelines highlight that a finding of low profitability does not necessarily signify that competition is working well, since low profitability may be concealing ineffective competition. Reasons for this may include:

(a) Weak competition as a result of customers not responding effectively to competing offers may sometimes result in an inefficient market structure in which operators have higher costs and set higher prices than would be the case in a competitive market.

(b) Incumbent firms, despite being protected from new entry, may not earn high profits because they are inefficient and operate with higher costs than would be sustainable with stronger competition in the market.[68]

4.75 We note that there may be certain legitimate reasons for variations in costs, such as:

(a) Higher costs coinciding with a higher quality of services where consumers can make informed decisions over what type of service to purchase.

(b) Variations in costs due to exogenous factors, such as cost differences based on location.

4.76 We also note that customers may not be able to assess the quality of advice firms provide on the services they offer, and this may lead to ineffective competition where there is over-provision of some services and under-provision of other services. Such ineffective competition may occur while finding low profitability.

[68] CC3 (Revised), paragraph 125.

4.77 We propose to assess potential inefficiencies through an analysis of costs, as well as through a review of internal documents.

4.78 **We invite views from interested parties to make submissions on whether there are specific cost metrics which would be informative in this assessment.**

Approach to profitability analysis for the independent vet businesses

4.79 In this section we set out our proposed approach to the profitability of independent vets. The structure of this section is as follows:

(a) We explain the limitations in the available data for the fragmented portion of the veterinary services market (ie the many independent vet businesses).

(b) We set out our proposed approach to identifying the independent vet businesses for which we intend to conduct profitability analysis.

(c) We set out our approach to assessing profitability for the selected independent vet businesses;

(d) We set out our approach to assessing potential inefficiencies.

Data challenges

4.80 Independent vet businesses (ie those other than the six LCGs) make up approximately 40% of the market and we estimate that there are 667 vet businesses, comprising 999 clinics. Analysing the profitability of so many individual businesses is a challenge.

4.81 Furthermore, there is limited publicly available information on the profitability of the independent vet businesses. This is due to the majority of them being small enough to meet small company reporting requirements and therefore producing only abridged or filleted accounts, in which there is no requirement to produce a profit and loss account.

4.82 It is therefore not possible to do a comprehensive analysis of the portion of the market comprising independent vet businesses using publicly available data.

Approach to analysis

4.83 Given the limited publicly available data and the fragmented nature of this portion of the market it is not feasible to assess the profitability of every independent vet. Therefore we propose to take the following approach:

(a) Conduct profitability analysis of all four of the mid-tier firms.

(b) Adopt a sampling approach to obtaining data and undertaking profitability analysis for the remaining independent vets.

4.84 As there is no existing complete list of veterinary practices within the UK,[69] we have created our own list from a range of sources. We have conducted further research to understand the ownership structures of these practices.[70] This has resulted in a list that includes most independent vet businesses in the UK and which we believe to be sufficient for the purpose described here.

4.85 From our discussions and from reviewing responses to initial information requests with independent vet businesses, we have concluded that accounting data useful for our intended profitability analysis is generally more readily available and reliable at a firm rather than veterinary practice level. We therefore propose analysing profitability at a firm rather than a practice level.

4.86 In drawing the sample, we have the opportunity to stratify by variables that are likely to impact on firms' profitability.

4.87 Gauging the total number of independent vet businesses to sample and issue with requests involves a trade-off between the resources required, both within responding firms and the CMA, to collate and process the information, and the need to have a sufficient number of responses to meet the CMA's analytical and evidential needs. Some of the requests for information that we issue to independent vet businesses will likely not lead to an eligible response, either because of non-response or because the firm also provides equine and/or large animal veterinary services (see paragraph 4.92). Taking these considerations into account, we will aim for a total of 50 responses, drawing a random sample of 70 firms with which to issue information requests to achieve this.

4.88 We further intend to stratify the sample to ensure that the selected vet businesses are proportionately geographically distributed across the regions of England and across Wales, Scotland and Northern Ireland.

Approach to estimating profitability

4.89 As a matter of principle, we consider that ROCE is the theoretically correct method for analysing profitability, for the reasons set out at paragraphs 4.1 to 4.4 above. However, the smaller vet businesses are owner-run, and may not have full-time accountants or bookkeepers, and as a result we consider that the information which we can reasonably collect from the smaller vet businesses in our sample is more limited that the information we can collect from the LCGs. For this reason,

[69] The RCVS maintains a register of veterinary surgeons, with some information on where they practice, but their list of veterinary businesses is not fully comprehensive.
[70] This included sending a short questionnaire to all the veterinary practices that we could identify, to ask questions about services offered, location and size.

and for the reasons set out in paragraph 4.874.87, we do not intend to collect asset valuation data from the smaller vet businesses. This means that the information we obtain will be insufficient to calculate a robust ROCE.

4.90 Instead, we propose to analyse profit margins of smaller vet businesses. These margins earned can then be benchmarked against the following:

(a) the actual margins earned by the LCGs' FOP activities; and

(b) our calculation of the normal margin which would be required for the LCGs to pay their debt and equity providers in a market-based WACC.[71]

4.91 EBIT margins will be used in the first instance. We shall consider whether earnings before interest, tax, depreciation, and amortization (EBITDA) is more appropriate once we have data on the prevalence of different asset financing strategies and depreciation policies.

4.92 For the reasons set out in paragraph 4.38, we propose to assess the profitability of the veterinary services operations of each smaller vet business as a whole, without seeking to assess separately the profitability of the different types of veterinary services. To the extent that any smaller vet businesses cater to other animal classes such as equine or large animals we will:

(a) consider the need to adopt a de minimis approach (that is, a certain proportion of revenues generated by out of scope services) so that we do not exclude rural vet businesses disproportionately; and

(b) propose to take into account the potential impact of out-of-scope activities in our interpretation of our profitability analysis.

4.93 We note that, in order to achieve a 'like for like' comparison, we are likely to have to adjust for the following items from the accounting data received:

(a) Staff remuneration where the vet is also the owner and is remunerated both for their work in practice and their share of the profits (possibly through a mix of salary and dividend payments). Here we would need to ensure that the salary cost to the business is captured but any share in the profits of the business is excluded. We would welcome comments from interested parties on how best to achieve this.

(b) Where FOPs lease assets for use in their business, or lease the property from which the business is carried out, this can impact our margin analysis when the results are compared to businesses which own these assets. This

[71] Normal EBIT margin = WACC*capital employed/(total operating costs including depreciation + (WACC*capital employed)). WACC is pre-tax. We may use EBITDA (earnings before interest, tax, depreciation and amortisation), if the depreciation policies are materially different between the largest and smaller providers.

is due to lease or rental payments being included in the costs of the business whereas there will be no equivalent costs for those businesses which own these assets. We are mindful of the potential impact of this distortion and propose adopting the same approach as set out for LCGs in paragraph 4.45.

4.94 Having calculated the profits made by the smaller vet practices in the sample, we propose to extrapolate our findings to the portion of the market comprising these smaller vet practices.

4.95 We may supplement our findings with further analysis, including in-depth studies of a smaller group of independent vets, in order to aid our understanding of the specific issues affecting them. For example, we might consider how scale affects profitability, in particular in the purchasing of medicines and consumables, and the feasibility of entry and expansion.

Assessment of potential inefficiencies

4.96 We propose to assess potential inefficiencies through an analysis of costs.

4.97 **We invite views from interested parties to make submissions on whether there are specific cost metrics which would be informative in this assessment.**

Additional analysis for diagnosis of profitability levels in the large corporate groups

4.98 Economic profitability analysis requires a number of assumptions to be made, to move from accounting profits to economic profits (see paragraphs 4.16 and 4.17). The results from economic profitability analysis can be sensitive to ranges around these assumptions, particularly with regard to asset valuations.

4.99 In our profitability analysis, we shall be mindful of the sensitivity of our analysis and results to key assumptions and undertake sensitivity analysis where appropriate.

4.100 In addition, we propose to undertake analysis to test the results obtained through our economic profitability assessment. This section sets out these proposed additional areas of analysis.

Review of acquisitions

4.101 We noted in the issues statement that a major development in the veterinary sector over the last ten years has been the rapid, significant, and ongoing growth of the LCGs through acquisition.[72] As part of the acquisitions process, the LCGs will typically have performed an investment appraisal calculation, which can provide useful insights into economic profitability.

4.102 We have requested acquisition documents from the LCGs, including investment appraisal calculations, and propose to assess the expected IRR for the acquisitions completed. Investment appraisals ordinarily forecast the expected cash flows, including the cash outflow for acquisition, from which an IRR is then calculated (being the discount rate at which the NPV of the investment would be zero). Where the IRR is larger than the firm's internal cost of capital (or hurdle rate) the investment is considered viable. IRRs in investment appraisals which significantly exceed our WACC estimate may therefore be a signal of high profitability.[73]

Internal documents

4.103 We propose to review internal documents on financial performance,[74] prepared for the board and/or management of the LCGs and their owners.

4.104 Whilst we recognise that internal documents are produced for a number of different purposes, we consider that when considered in the round, alongside other evidence, statements by firms on their profitability are relevant and informative to our overall assessment.

Margin benchmarking

4.105 We have considered whether broader price and/or profit margin benchmarking may provide useful insight into the extent to which the LCGs' prices and/or profits reflect those that one would expect to see in a well-functioning market. For example, a comparison of the prices of, or profit margins earned on the supply of, similar veterinary services in other countries, or in other professional services in the UK, might provide an alternative view on UK prices and/or profits.

4.106 However, we also recognise that price and/or margin benchmarking may have some limitations. In particular, where firms operate in different countries or sectors, they may:

(a) Provide services beyond the services which are in the scope of our investigation.

[72] CMA issues statement, paragraph 59.
[73] Assuming expectations are realised.
[74] We may supplement this analysis with publicly available documents and stockbroker reports on the sector, including analyst reports on CVS and Pets at Home.

(b) Face different risks to those faced by the LCGs, including different regulatory requirements.

(c) Face different costs to the cost bases of the LCGs.

(d) Have different reporting requirements and/or accounting policies for material items within the profit and loss account such as capitalisation and subsequent write-off of capital expenditure.

4.107 We consider that benchmarking is unlikely to yield robust conclusions and we therefore do not propose to pursue this avenue of inquiry further. **Nevertheless, we invite interested parties to make submissions on whether there are specific price/profit benchmarks from other countries that we should consider and the extent to which these are comparable with the supply of veterinary services in the UK.**

5. Consultation

5.1 We welcome views from interested parties on our proposed approach to the profitability analysis as set out above.

5.2 In particular, we would like views on the following:

(a) For revenues or costs which are not associated with a single activity, the appropriate basis for the allocation of these costs.

(b) For assets and liabilities which are not associated with a single activity, the appropriate basis for the allocation of those assets and liabilities.

(c) The appropriate basis on which to make an adjustment to firms' operating costs to reflect the 'standalone basis' element, in order to ensure that sufficient costs are allocated such that a standalone firm could operate with the level of central costs included.

(d) For the assessment of potential inefficiencies through an analysis of costs, whether there are specific cost metrics which would be informative in this assessment.

(e) Whether there are specific price/profit benchmarks from other countries that we should consider and the extent to which these are comparable with the supply of veterinary services in the UK.

5.3 Any submissions must be provided no later than **5:00pm on Friday 22 November** by emailing: **VetsMI@cma.gov.uk**

5.4 We intend to publish all responses from businesses and other organisations on our case page except those marked as confidential. Please clearly highlight any confidential information in your submission and provide a non-confidential version of your submission for publication.

5.5 We may also decide to publish anonymised submissions from individuals on our case page. Please clearly mark your submission as confidential if you do not want it to be published and let us know if you would prefer not to be named.