22 November 2024

CVS Response to CMA “Approach to profitability and financial analysis” Working Paper of 1 November 2024

CVS welcomes the opportunity to comment on the CMA’s proposed methodology to assess profitability as part of its market investigation. As a public company which must report its performance to shareholders and the broader market, CVS has strong views on how its profitability should be assessed.

CVS understands that the CMA’s financial and profitability analysis is economic in nature and designed to answer specific questions on the competitiveness of the veterinary sector. We address various technical and economic aspects of the CMA’s proposed methodology in a separate submission by our economic advisors, CRA, appended to this response. However, there are a number of critical elements of the market reality CVS face which must inform the CMA’s understanding of how competition works for CVS in particular, and in the veterinary services market in the UK. In particular:

- The veterinary services market in the UK is currently widely acknowledged to be underserved. There has been a significant surge in demand for veterinary services, due to both an increase in the number of pets and wider expectations of pet owners for the highest quality of veterinary care. CVS can only invest to expand its provision of veterinary services by raising capital from equity and debt markets. Of course, the commercial reality is that these investors have return expectations that CVS must meet if it is to be able to continue to invest and grow. CVS’ returns are only at the level required to attract such investment. Furthermore, in considering these returns, CVS’ investors are comparing them to CVS’ full capital base including goodwill.
- In CVS’ experience, the veterinary services market is highly competitive, where entry and consumer switching are easy. Efficiency of operations is therefore critical to being able to provide quality veterinary care while remaining profitable. This applies not only to CVS’ First Opinion Veterinary Practices (FOVPs) but also to its broader operations (including out of hours (OOH) provision, referral centres, diagnostic laboratories and crematoria), where fixed costs are high and good capacity utilisation is critical to achieving viability.
- CVS sees itself as part of the solution to many of the challenges facing the veterinary sector in the UK. In particular, by supporting the training and retention of high-quality veterinary professionals (including not only vets but veterinary nurses and support staff). Veterinary practice will remain a challenging working environment, and CVS expects a continuing upward trend in demand for veterinary services as young pets acquired during the pandemic start to reach old age. In addition, Brexit more generally, as well as the recent replacement of the Government’s Shortage Occupation List and changes to the minimum salary threshold under the Skilled Worker visa scheme, have created additional challenges in the recruitment of qualified veterinary surgeons from outside of the UK. CVS meets this growing demand through investing to improve recruitment, training and retention of veterinary professionals at its existing sites, but also by pursuing both greenfield opportunities (where CVS looks for underserved areas that need increased veterinary service provision) and acquisitions to fill gaps in CVS’ existing network.
- CVS focuses its acquisitions and greenfield opportunities on areas that are *complementary* to its existing operations, and not on any attempt to gain market power in particular local areas or to raise prices. There is no systematic difference in expected profitability between

greenfield sites and acquisitions. This runs directly counter to the existence of material market power. If existing sites held market power, then CVS would be incentivised to focus much more strongly on its own greenfield developments (where it would pay only the cost of developing the site) rather than acquisitions (where competition with other corporate suppliers would force CVS to also pay the value of the market power).

- Finally, although CVS recognises the difficulty of making meaningful international comparisons, CVS' direct experience in other countries indicates returns at a similar level, notwithstanding a generally lower share of corporate vet groups in those countries.

CVS provides further evidence on each of these points below – and is happy to discuss these further during meetings/hearings in the future.

CVS' returns are only at the level required to attract investment

Whatever the results of the economic analysis discussed in the appendix to this submission, it is important to recognise the market reality that CVS is operating in is one where its returns are already only just at the level required to facilitate further investment in new FOVP sites and the broader services that support them. This is clearly evidenced by broker reports for CVS' recent results.

For example, brokers who have considered risks associated with the CMA investigation have commented that on their calculations, CVS' post-tax ROCE over a 5-year average was in fact lower than their estimated WACC.

As can be seen from the appended CRA report, CVS' ROCE is broadly in line with its WACC. That is, CVS is only just earning sufficient returns to enable it to reward investors to the extent necessary to raise new capital and continue to improve the supply of veterinary services in the UK through an expanded network of FOVPs and complementary services.

CVS' investments are focused on improving and broadening its offer, not concentrating market power

As can be seen from the documents submitted to the CMA to date, CVS' greenfield FOVP investments are focused on those areas where the local market is currently under-served (e.g. due to large new housing developments paired with a relatively low number of current veterinary providers), and areas where a new FOVP could contribute significant additional business to existing complementary service offerings (OOH, referrals, labs and crematoria) where economies of scale are essential to viability and profitability. CVS' strategy is to focus investments on areas with strong demand, but where there is minimal cannibalisation of CVS' existing FOVPs (while still allowing for synergies with OOH, referrals, labs and crematoria services, which have a larger geographic catchment area).

CVS does not expect greater profits from acquisitions than from greenfield opportunities

In order to meet customer needs and expand CVS' offering across a wider geographic footprint, CVS both acquires existing FOVPs and builds new ones. This in itself is inconsistent with a view that the goodwill paid for existing sites reflects market power. If this were so, then the tangible and intangible costs of building a new FOVP from scratch would be markedly lower than those of acquiring an existing practice (given the latter would include the value of the market power, which CVS competes against other corporate groups to acquire, whereas the costs of setting up a

greenfield site would not incorporate any such value). In this hypothetical scenario it would not be logical for CVS to grow by acquisition given it is capable of building sites from scratch. Hence, goodwill is a real cost of CVS doing business in this industry and represents assets that can't easily be measured by traditional accounting standards, but assets that still require capital and investment such as building a well-respected local brand to attract new clients in the future.

The value of goodwill that CVS pays for acquisitions (as set out in the CRA appendix to this submission) can be readily explained by the true competitive value (including on a "cost to build" basis) of the assets it acquires, including those that are not itemised on the balance sheet due to accounting standards. These include:

- Tangible assets that are not included on the balance sheet (because they were not recorded by the seller or have been largely/fully depreciated, but retain significant value in use, or in relation to land assets, because they have appreciated in value in ways that are not recorded on the balance sheet);
- The value of the local brand – CVS does not record brand value on its balance sheet, but continues to operate under the trading name of the businesses it acquires (albeit while also identifying the site as part of the CVS Group) – reflecting the local brand value embodied in those brands;
- The value of the team of veterinary professionals and their know-how put together by the seller (which again is not valued directly as a separate asset on the balance sheet). This people asset is arguably the greatest asset in any service industry such as the veterinary sector as it is the people that deliver the service to clients and their animals;
- The value of the business's local reputation and resulting customer lists (which is valued on the balance sheet, but in a conservative manner that does not reflect the full value of this asset).

Consistent with the fact that CVS invests in both acquisitions and greenfield developments, it sees the returns on both types of investment as similar (based on acquisition valuations that *include* the value of "goodwill" – which in turn reflects the un- and under-recorded tangible and intangible assets set out above).

It is of course theoretically possible that a portion of goodwill might represent some form of overpayment for acquisitions by corporate groups such as CVS. However, this is highly unlikely given (a) there is a competitive pool of potential buyers for acquisition opportunities, including the six established corporate groups and a number of smaller acquirers, and (b) it is easy for each of these corporate entities to open greenfield FOVPs which provide similar returns.

CVS also notes that the increasing consolidation of the UK market has not resulted in improved financial results for CVS – whose EBITDA has been fairly stable at between 13-16% over a long period.[1]

CVS does not see higher profits in the UK than in other countries where it operates

Although CVS is focused on the UK market, it does also operate FOVPs in Australia (where it has purchased 25 practices in the period since July 2023, comprising 32 practice sites). As set out in

[1] Measured consistently on a pre-IFRS16 basis, and treating RDEC as a tax credit.

CVS' annual report, Australia is now the focus of its acquisition activities, with the UK de-emphasised due to the uncertainties of the UK market. CVS' experience in Australia is that practice margins are slightly higher than in the UK, despite the Australian veterinary services market being significantly less concentrated (with two major established competitors together serving around 11% of the market, and around 15% corporate ownership overall).

Experience of one of CVS' major shareholders on their investments across different geographic markets further supports this view, based on their investments in veterinary service groups in the UK, Australia and USA.

- Their estimate is that CVS earns around 17% EBITDA margins – or around **15%** excluding the benefit of the RDEC tax credits that have only been earned in recent years. CVS has in the last couple of years been investing around 5-7% of its revenue on capital expenditure (capex) each year (compared to only 3-4% in earlier years).
- In Australia, they estimate that National Veterinary Care (one of the top 2-3 corporate groups there prior to its acquisition in 2020) earned an average 16-17% EBITDA, with capex spending at only 2-3% of sales (despite, as noted above, an even less concentrated Australian veterinary services market than is seen in the UK).
- In the US, they estimate that VCA Antech (which was one of the top 2-3 corporate groups in the USA prior to its acquisition in 2018) averaged around 18% EBITDA margins while spending around 4% a year on capex. This is despite the fact that corporate ownership of veterinary practices in the US is around 25% today (and would have been meaningfully lower in the relevant period of 2010-2018 in their estimation).

In the experience of this major CVS shareholder, none of these entities saw EBITDA margins increase as consolidation in the markets in which they operated increased. If a rise in corporate consolidation were to result in a less competitive market which isn't functioning well, one would expect meaningfully higher margins for corporates in the UK than for those in the USA or Australia. This isn't the case and if anything, returns in the UK are lower, with corporate groups in the USA and Australia being more profitable despite less consolidation in those markets.