Economic comments on the CMA's Profitability Methodology Working Paper for Veterinary Services

22nd November 2024

1. OVERVIEW AND SUMMARY

1.1. Overview of findings

We have been asked by CVS to consider the CMA's Profitability Methodology Working Paper from an economic perspective, as a complement to CVS's commercial feedback (supplied in their main response). Many elements of the working paper are common to previous CMA profitability analyses and we do not comment on those in any detail. For example, we agree in principle that the Return on Capital Employed ("**ROCE**") of an industry can tell us something about the competitiveness of that market – but also that this exercise is often highly dependent on its assumptions, and in particular that the measurement of capital employed is often fraught with difficulty.

We also note, as the CMA accepts, that there may be reasons why the return on capital exceeds the cost of capital that are entirely consistent with the effective working of a competitive process – for example because:[1]

- signals from higher returns following a demand (or supply) shock may take some time to bring new capital/assets/staff into the market; and/or
- firms that manage to differentiate themselves in a way that adds value to customers above those of rivals (or reduces costs below those of rivals) should be able to earn a return on that value added, raising profits above the cost of capital.

In this particular case, a critical issue will be to understand what assets underlie the "goodwill" that CVS (and others) recognises when they acquire an independent First Opinion Veterinary Practice ("**FOVP**"). We note the CMA's concern that such "goodwill" may in principle capture the crystallisation of any market power that the acquired independent vet might have held, and as such should not be included in an economic estimate of the returns one would expect to see in a competitive market. However, it is worth noting that this is not a market where CVS has been acquiring large businesses that clearly hold such market power – but rather a number of small independent practices, that help it to generate economies of scale and scope when combined with CVS's central systems, know-how and broader set of services. Therefore, it should not be assumed that the extent and impact of any such market power would be material.

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1 See the CMA's "Guidelines for market investigations" (CC3), paragraph 117: *"At particular points in time the profitability of some firms may exceed what might be termed the 'normal' level. There could be several reasons, including cyclical factors, transitory price or other marketing initiatives, and some firms earning higher profits as a result of past innovation, or superior efficiency."*

At the same time, it is clear that "goodwill" is, in practice, also capturing a range of important assets, that would exist even in the most competitive market imaginable but are not recorded elsewhere on the balance sheet. In this paper we focus particularly on two such categories of assets which are likely to be material in scale, and reflected in the goodwill recognised on CVS's balance sheet for acquisition sites, namely:

- tangible assets that are missing or over-depreciated, and
- intangible assets such as local brand and reputation (customer relationships, local know-how, trade names etc) that are built up over time by FOVPs.

We also identify other categories of missing assets (e.g. the intangibles created by setting up centralised systems that allow CVS to ensure a uniformly high quality of service across its network of veterinary practices – such as staff development and R&D) that are difficult to quantify, but likely to be important to CVS's returns.

Therefore there should be no ex-ante expectation that such crystalised market power exists to any material degree, and it should not be surprising if the analysis in fact shows that "goodwill" is entirely explained by a number of hard-to-measure but genuine tangible and intangible assets, the value of which do not depend on, or reflect, market power.

If the true value of these tangible and intangible assets is not properly captured (either by including goodwill directly and/or through a "bottom up" assessment of their real value), then the analysis risks ignoring critical assets, and finding an excess return on capital when, in reality, there is none.[2] Given the difficulty of accurately recording the value of these assets, in our view any such exercise will need to be subject to significant sensitivity testing to alternative assumptions.

1.2. Structure of the response

In this response, we focus in particular on the industry-specific elements of the CMA's proposed approach in this case where economic principles are applicable. Based on our understanding of the market, including the submissions we have seen from our client, we have identified a number of areas that are likely to be critical to obtaining a meaningful profitability measure for CVS, and for the veterinary market more generally.

a) **Level of assessment:** We understand that the CMA proposes to focus its return on capital employed ROCE analysis at the level of UK veterinary services (including not only small animal FOVPs, but also farm/equine practices and out of hours ("**OOH**") services, as well as referral centres, diagnostic laboratories, and crematoria). We can see the logic for this approach given data availability, and particularly the challenges of meaningfully allocating capital across these activities. However, we note that it will limit the extent to which profitability can be meaningfully compared across firms. We also discuss below what inferences can (and cannot) be drawn from the CMA's proposed comparison of margins across activities.

b) **Valuation of tangible assets:** As CVS already set out previously, it is likely that fixed assets such as equipment, fixtures and fittings are significantly undervalued in the asset register (due both to missing and over-depreciated assets) which, for acquired assets, will instead be captured in "goodwill". We therefore propose a method by which a more accurate figure for

2 Indeed, in relation to parts of the business that CVS built itself rather than acquiring, there is no "goodwill" under relevant accounting rules and therefore even the inclusion of "goodwill" may understate the true capital employed in CVS as a whole.

these tangible assets could be derived. We also discuss the issues raised by the CMA in relation to the capitalisation of operational leases and the valuation of owned property and land assets.

c) **Valuation of intangible assets:** As the CMA recognises at paragraph 4.56 of the Working Paper, CVS will hold a number of intangible assets (specifically the local brand, knowhow and reputation assets mentioned above) that are not recorded specifically on its balance sheet but are rather captured in "goodwill", at least in relation to acquired sites.[3] We set out below some principles that could be used to value such assets, based on the costs (rather than only the "losses") incurred in the start-up phase of a greenfield FOVP. The same principle could be applied to other parts of CVS's business, such as referral centres, laboratories and crematoria, whether acquired or developed as greenfield projects.

d) **WACC:** We recognise that the CMA may be forced to calculate an industry level WACC for its assessment of industry-wide profits, and potentially in relation to rivals for whom there is no clear measure of WACC (e.g. because they are privately held, or part of a broader corporate group involved in other activities or geographies to a greater extent than CVS). However, in relation to CVS's own profitability we do not see any reason to deviate from CVS's own WACC. Moreover, any industry-level assessment will need to take account of the fact that the capital base and the cost of that capital is likely to differ across firms. For example, private equity owned groups will tend to have high leverage and hence a higher proportion of relatively cheap debt capital than for CVS as a listed company. WACC may also be substantially higher in the independent sector, given the risks and liquidity constraints faced by investors in small firms.

e) **Cost inefficiency:** The Working Paper's comments on cost inefficiency are extremely high level and provide no guidance on how the CMA intends to approach this analysis. We have not seen any evidence to suggest that there are material cost inefficiencies in the veterinary sector – and indeed the relatively unconcentrated nature of the market at a national level, and the strong competition for the acquisition of veterinary sites (on which the acquiring firm must then provide a return for its investors) will create strong incentives to operate in an efficient manner. Indeed, the fact that corporate entities have been increasingly likely to acquire independent vet practices in the UK over time may well reflect cost efficiencies that can be achieved through the complementarities and cost synergies that exist in a corporate structure (e.g. in relation to procurement, staff training and management, the provision of OOH and specialist services) compared to a fragmented and vertically non-integrated independent sector. Any analysis the CMA conducts on cost efficiency also needs to ensure that it is comparing "like for like" in terms of the quality of service that is being provided.

f) **Profitability of mid-tier and independent vets:** Given the important combined scale of independent vets in the market (comprising over 40% of the market),[4] we understand the desire to assess the profitability of these firms also. However, given the difficulties of assessing their capital employed accurately, we have doubts over how meaningful a simple comparison of margins will be. Moreover, independent vets will inevitably be run rather differently to corporate vets. For example, they may suffer cost inefficiencies in relation to functions like procurement, staff training and complaint handling, as well as in relation to raising finance, which may make them seem less profitable compared to the corporate vets, and will not generally benefit from

3 For greenfield sites these assets will simply be missing from the balance sheet altogether.

4 CMA Decision to make a market investigation reference, 23 May 2024, paragraph 10, mentions that the six large corporate groups together own nearly 60% of vet practices.

the vertical efficiencies associated with integration into services like OOH provision and referral or diagnostic centres. On the other hand, if being prepared for sale, they may have had costs stripped out in ways that are not sustainable in the longer term (e.g. with very high caseloads per staff member), which may boost their short-term profitability. Their owners may also take a reduced salary, earning further compensation through dividends or rental income, which again will give a skewed view of the true profitability of these practices. These differences do not reflect any difference in the competitive pressure faced by independent versus corporate veterinary practices, but nonetheless may well result in quite different observed margins.

g) **IRR of acquisitions:** While we can understand the logic for looking at the IRRs of acquisitions, this needs to be done with care, and to take account of the range of reasons why IRRs could be higher for some acquisitions than others (many of which may be pro-competitive: for example, reflecting the efficiencies of bringing practices into a larger network of services such as OOH or referral services).

In relation to international comparisons, we agree that it is difficult to conduct truly "like for like" comparisons against the profitability of FOVPs in other countries, given the other respects in which these markets may vary. However, we note that CVS does have some experience of operating in other veterinary markets, in particular in Australia, where its experience is that returns on capital in that market are higher, notwithstanding the fact that there is less consolidation in that market and that there is a higher corporation tax rate in Australia than in the UK. This is discussed in CVS's submission.

Each of these issues is discussed in greater detail in the Sections below. Taken together, there is strong evidence that the large value of goodwill on CVS's books relates to real (tangible and intangible) assets, consistent with a competitive market.

2. LEVEL OF ASSESSMENT

We agree that, given the difficulties in splitting assets and costs meaningfully across CVS's various UK veterinary activities, it makes sense to look at the overall performance of CVS's UK veterinary business. However, in doing so it is of course critical to ensure that capital and profitability are accurately and fully recorded across all parts of the business. Moreover, looking at CVS overall will mean its financial performance can only be meaningfully compared with businesses with the same or very similar business models, and whose capital and profitability is recorded/measured in a comparable way.

In this section, we set out what CVS's profitability would look like on this basis, (using accounting data submitted to the CMA previously). This generates an implied return on capital broadly in line with CVS's WACC.

We recognise that this calculation incorporates goodwill in the asset base. As we describe in more detail in Sections 3 and 4 below, a separate exercise can be done to identify in a more granular fashion the actual tangible and intangible assets that underlie this measure (and may in fact outstrip it, in relation to parts of the business that CVS has built from scratch rather than acquiring). However, our concern is that in practice such an approach would still not fully cover all the competitive assets on which CVS legitimately earns returns, as many of these are difficult to value. In any case, the published accounts (including goodwill) represent the commercial reality faced by CVS and its investors, and on which investors will assess CVS's performance (and make decisions on the return required to provide capital to CVS in the future).

Importantly, it is unlikely that this "goodwill" figure in practice reflects material amounts of market power. The businesses that CVS has acquired, and on which the goodwill in its accounts is based, are not (as in some markets) large businesses with local monopoly power, but rather a series of small independent

FOVPs through which CVS has expanded its national footprint, in order to optimise the efficiency of its central resources (including efficient utilisation of OOH, laboratory and crematoria capacity, economies of scale in procurement, training and staff management, know-how, and vertical integration into a range of related businesses that are not achievable by a small stand-alone FOVP).

We have not seen any evidence of particular barriers to local entry in this market, beyond the difficulty of hiring and retaining suitable veterinary staff, which applies to existing as well as new practices. Indeed, RCVS data on practice numbers collected by CVS shows that 187 new independent sites were established in the year to 31 October 2024. When deciding to purchase a going concern rather than build its own FOVP in an area, CVS will take account of the time, cost and risks that would be involved in building such a practice from scratch. As we will show in Sections 3 and 4 below, even just taking account of the true tangible asset value of these businesses and the extent of start-up costs that CVS avoids by acquiring a going concern can already explain a large portion of the "goodwill" recorded on CVS's books, without any need for market power as an explanation.

Neither is there any evidence in CVS's behaviour that market power explains a material part of the value that it is willing to pay for these businesses. In a market with substantial local entry barriers, acquisition values could be bid up above the levels that would exist in a competitive market with low entry barriers. However, in this market CVS and others (including independents) also expand through the organic development of new sites. If acquisition values (and therefore the "goodwill" that results on the balance sheet from such values) incorporated significant returns to market power, then it would generally be more cost effective for firms like CVS with experience in building greenfield practices from scratch to do that, and thereby create their own position of market power at ***cost***, rather than to pay a local independent incumbent for their existing market power at ***value.***

Therefore in our view there is significant value in starting from an assessment of the accounting position, and only then stress-testing this commercial view against alternative methods to assess the competitive capital base of CVS and its rivals.

We also set out some initial views on CVS's margins by business area, which the Working Paper indicates the CMA will also review. For all the reasons the CMA has set out in its guidance,[5] a comparison of margins without information on capital employed is not in practice very meaningful. We would expect that in a competitive market, more capital-intensive activities would result in higher returns as a share of revenue (whether or not that capital is recorded on the balance sheet). Therefore, in our view, there are limited insights that can be gained from such an analysis, without further information on the level of capital required to generate the observed returns.

2.1. UK operations ROCE

ROCE figures were calculated using capital employed and EBIT based on the general principle that all revenues, costs, assets and liabilities necessarily arising from the operation of the business to supply the in-scope activities are included. By the same reasoning financing costs and taxation on income and any associated corporation tax or deferred tax are excluded.

In the tables below, operating profits are determined by deducting depreciation, amortisation and impairment costs from CVS's operating margin (which deducts direct operating costs from revenues). Net operating capital was estimated as the difference between its overall operating assets (both tangible and intangible) and liabilities. As per the CMA's preferred methodology set out above, costs and assets

[5] Guidelines for Market Investigations (CC3), paragraphs 112, 117-120.

associated with financing or taxation were excluded from the calculation. ROCE is then calculated by dividing operating profit by the amount of net operating capital employed to provide veterinary services.

The table below summarises the financial information used in estimating CVS's ROCE across its overall UK operations, based on CVS's standard accounting data (as previously submitted) in response to RFI6.[6] Based on CVS's public statements around the publication of its accounts, we understand that reported 2023 profitability was overstated and 2022 understated, due to a number of one-off factors.[7] Therefore it makes sense to review these results over the full three-year time period "in the round", rather than drawing any conclusions on trends. The figures below are also adjusted to strip out RDEC credits (which are recorded as a negative cost due to accounting standards, but are in reality a tax credit).[8]

Table 1: Calculation of operating profit FY21-FY23 (£'000 and % revenue)

	FY2023	FY2022	FY2021
Revenue	**[✂]**	**[✂]**	**[✂]**
Operating Margin	**[✂]**	**[✂]**	**[✂]**
	[✂]	**[✂]**	**[✂]**
Depreciation	**[✂]**	**[✂]**	**[✂]**
Amortisation	**[✂]**	**[✂]**	**[✂]**
Impairment/Other	**[✂]**	**[✂]**	**[✂]**
Operating Profit	**[✂]**	**[✂]**	**[✂]**
	[✂]	**[✂]**	**[✂]**

Source: CVS Financial Templates FY21-FY23

6 In line with the RFI6 submission, the UK operations P&L is provided on a pre-IFRS16 basis, with adjustments for IFRS16 reported separately in column AP. We have reported margins on the submitted basis, but in order to have consistency between P&L and Balance Sheet approaches in Table 2 (reporting ROCE), we have made an adjustment to the P&L to ascribe back IFRS16 adjustments to the P&L, so that both P&L and Balance Sheet are reported on a comparable basis. This means that operating margins are not identical across Tables 1 and 2.

7 Our understanding is that in FY2023 CVS benefitted from a certain degree of "catch up" on its RDEC R&D tax credits, and suffered some one-off impairments in FY2022 related to its acquisition and then divestment of Quality Pet Care Ltd.

8 If profitability were instead reported including the RDEC as a negative cost, ROCE for the three years would be **[✂]** in 2023 and **[✂]** in both 2022 and 2021.

Table 2: Calculation of ROCE FY21-FY23 (£'000 and % revenue)

	FY2023	FY2022	FY2021
Revenue	[✂]	[✂]	[✂]
Operating profit (1)	[✂]	[✂]	[✂]
	[✂]	[✂]	[✂]
Capital employed (2)	[✂]	[✂]	[✂]
ROCE (1/2)	[✂]	[✂]	[✂]

Source: CVS Financial Templates FY21-FY23 (adjusted for IFRS16 consistency and to remove RDEC credit).

Across its overall UK operations, CVS therefore earned an average ROCE of around **[✂]** during this period, which is in line with its WACC. Therefore, there is no indication in CVS's book results of excessive returns on capital.

2.2. ROCE by business unit

Although we understand that the CMA is planning to look at ROCE at the level of overall UK operations, in response to RFI6 CVS has been able to provide some splits of P&L and balance sheet items across its business units – specifically, Veterinary sites, Labs, Crematoria and Online Retail (although there remain substantial costs that are recorded centrally, and not allocated to these units – such that profitability at this level will be inflated). The below table sets out an overview of CVS's estimated ROCE for each of these business units from FY21 to FY23 based on those previous submissions.

CVS's ROCE for its Veterinary Practice division averaged around **[✂]** over the last three financial years. The average ROCE declined over this period, driven by an increase in the capital employed in its veterinary practices divisions by over **[✂]** (reflecting a strategy to invest more heavily in both new acquisitions, property relocation and refurbishment, and new clinical equipment).[9] Over the same period operating profits remained fairly stable. Again, these returns are broadly in line with CVS's WACC (particularly taking into account that the Veterinary Practice business unit in particular must also make a substantial contribution to the CVS Group's central overheads).[10]

Table 3: Overview of CVS' UK operations ROCE by business unit (£'000)

Business Unit		FY2023	FY2022	FY2021
Veterinary Practice	Operating margin	[✂]	[✂]	[✂]
	Operating profit	[✂]	[✂]	[✂]
	Capital employed	[✂]	[✂]	[✂]
	ROCE	[✂]	[✂]	[✂]

9 See CVS's Capital Markets Day Investor Presentation from 2022 for an indication of how it planned to invest across these areas: https://www.cvsukltd.co.uk/globalassets/capital-markets-day-presentation/cvs-capital-markets-day-presentation-2022.pdf

10 If central overhead costs were allocated fully to the Veterinary Practice, as the largest business unit, as a proxy for what a "stand-alone" Veterinary Practice unit's profitability might look like, ROCE would be reduced by around 1ppt each year.

Business Unit		FY2023	FY2022	FY2021
Laboratories	Operating margin	[≫]	[≫]	[≫]
	Operating profit	[≫]	[≫]	[≫]
	Capital employed	[≫]	[≫]	[≫]
	ROCE	[≫]	[≫]	[≫]
Crematoria	Operating margin	[≫]	[≫]	[≫]
	Operating profit	[≫]	[≫]	[≫]
	Capital employed	[≫]	[≫]	[≫]
	ROCE	[≫]	[≫]	[≫]
Online retail	Operating margin	[≫]	[≫]	[≫]
	Operating profit	[≫]	[≫]	[≫]
	Capital employed	[≫]	[≫]	[≫]
	ROCE	[≫]	[≫]	[≫]

Source: CVS Financial Templates FY21-FY23

By contrast, CVS's ROCE on Labs and Crematoria **[≫]**. However, this reflects important assets that are missing or under-recorded for these business units.[11] Specifically:

- In relation to **Crematoria**, CVS owns **[≫]** crematoria sites, resulting in very low **[≫]** at this business unit. Moreover, freehold land values will not have been updated, leaving the capital value of Crematoria assets understated. For example, CVS recently relocated its Valley Crematorium to Paignton at a cost of **[≫]**. By contrast, the tangible assets across all seven of CVS's crematoria sites was only valued at **[≫]** in 2023 – suggesting that the capital valuation of the older/more depreciated sites is likely to be substantially understated.
- In relation to **Laboratories**, recent profitability will reflect a capital base that is largely depreciated but still provides substantial benefit to the business. This includes CVS's analysers, **[≫]**, and the Laboratory Management System (LMS), **[≫]**. Similar issues to crematoria also apply to the sites, **[≫]** freehold, meaning that land values are likely to be undervalued, and property may be over-depreciated.
- In relation to **Online Retail**, excluding financial assets results in a negative capital base, resulting in negative ROCE, which of course is not very meaningful. In CVS's view this is due to significant **[≫]** reflecting the nature of retail as a relatively asset light business, where major assets (such as the brand, customer relationships and website) will be either partially or fully excluded from the balance sheet.[12] Indeed, the online retail business also benefits from other assets (e.g. CVS's Diss warehouse, pharmacy robots and an automated packing machine) that are reported at Group level and not for the Online Retail business specifically.

More generally, for all these business areas we understand that intangibles will likely be understated, as they were set up or acquired many years ago, and any initial goodwill which was recognised in

11 Albeit, as noted above, there will also be missing and undervalued assets in relation to Veterinary Practices, even when goodwill is included, in relation to greenfield sites and central operations that were built from scratch, and where tangibles may nonetheless be over-depreciated and intangibles not fully captured.

12 Specifically, including financial assets results in a ROCE of **[≫]** in 2021 and 2022, and **[≫]** in 2023, reflecting a large decline in net assets in that year.

respect of any acquired business is therefore largely depreciated – yet clearly in reality these businesses still benefit from reputation, customer relationships, cohesive staff teams, etc. of the type described in Section 4 in relation to FOVPs.

2.3. Other profitability measures

The Working Paper sets out that the CMA is also minded to compare margins across different market activities.[13] Although there is no competitive mechanism that we could expect to align gross margin across business units, we would broadly expect higher gross margin for markets that are more capital intensive (so a higher gross margin on revenue is required to provide a reasonable return on capital) and/or less competitive. The problem is that, unless the capital intensity of these different activities can be measured (in which case we could directly calculate a ROCE), then simply reviewing margins will not allow us to draw inferences on whether high margins are caused by a lack of competition, a high capital intensity or some other factor.

Of course, as set out above, there is also scope for returns above the cost of capital even in competitive markets – for example due to firms developing a better offer and/or lower cost structure than their rivals, from which they can (and should) be able to profit. These factors will also inflate margins but should not be a cause for competitive concern unless they create substantive barriers to entry or expansion that rivals cannot overcome. There can also be scope for temporary increases in sector-wide profitability above zero in a competitive market where there are supply and/or demand shocks (of the type seen in the veterinary sector around Covid and Brexit) and some lag in response (e.g. due to the difficulty of hiring and retaining newly qualified vets, given the very long time it takes to train them).[14]

In light of all these factors we are sceptical of the value of reviewing margins on a more disaggregated basis. Nonetheless, in light of the CMA's proposed approach, and of the data already submitted by CVS previously, we comment on profits for each business unit below.

2.3.1. Margins by business unit

CVS already submitted data on margins and operating profits by business units in response to RFI6. These are summarised below for FY2023/24 based on that submission, for ease of comparability, with Veterinary Practices margins split between Local Clinics and Referrals. Note that although data was requested (and provided) separately across local clinics, referral centres and wholesale medicines, all three of these activities are run jointly by a single CVS business unit and are not separated out in the normal course of business. Neither does CVS hold a meaningful split of capital assets between these activities. Therefore it is more meaningful to look at these results at the combined business unit level at which CVS operates (i.e. Veterinary Practices), rather than based on these sub-activities. Moreover, although for simplicity the table below presents results for FY2023 alone, results for any individual year can be distorted by one-off events (particularly at this more granular level). For example, the apparent profitability of referrals **[✂]**.

13 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.40.

14 This refers to a typical University Course taking 5-6 years: https://www.bva.co.uk/your-career/becoming-a-vet/

Table 4: CVS profitability by business area FY2023 (£'000s and % revenue)

	Revenue	EBITDA		Operating Profit	
Local clinics	[✂]	[✂]	[✂]	[✂]	[✂]
Referrals	[✂]	[✂]	[✂]	[✂]	[✂]
Wholesale medicine	[✂]	[✂]	[✂]	[✂]	[✂]
Total Veterinary Practices	[✂]	[✂]	[✂]	[✂]	[✂]
Labs	[✂]	[✂]	[✂]	[✂]	[✂]
Crematoria	[✂]	[✂]	[✂]	[✂]	[✂]
Online retail	[✂]	[✂]	[✂]	[✂]	[✂]

Source: CVS Financial Template FY23

There are some notable differences in margins across the different elements within the Veterinary Practices business unit. In particular, **[✂]**.[15]

2.3.2. Margins by site

The Working Paper also indicates that the CMA will look at operating profits at the level of each individual FOVP site.[16] It is not clear to us precisely how the CMA intends to approach this exercise, or what use would be made of it. There are a few points of caution we would raise even at this early stage, however:

- First, it will be important to look at profits at least at a practice rather than site level – as CVS has set out in previous submissions, there are many instances where costs will not be accurately allocated to an individual site (e.g. staff costs may be recorded at the "central" site of a practice, or the site at which they most frequently work, rather than allocated across all the sites where they provide services and generate revenue).
- Second, it will be important to take account of the life-stage of the practice in question. For example, recently acquired practices that were "prepared for sale" by their previous owners may have been running at unsustainable staffing/cost levels, and therefore may temporarily appear to have EBITDA above a sustainable level. On the other hand, sites that are early or late in their life may be less profitable than would be commercially sustainable over the medium term.
- Third, it will be important to take account of differences in the capital intensity of different practices. For example, practices that are very well equipped and undertake a high proportion of higher value/margin work using expensive equipment should have a higher EBITDA in a competitive market.
- Fourth, it will be important to recognise that staff turnover can have a major impact on site-level profitability. In CVS's experience, **[✂]**. This results in higher profitability but also a better

15 **[✂]**

16 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.40.

service for customers – and so should not be interpreted as evidence of problems or harm in that local area.

Given these difficulties in meaningfully understanding and controlling for the competitively driven differences between site or practice-level profitability, we are sceptical of the value of such an exercise.

3. TANGIBLE ASSETS

As CVS set out previously, there are reasons to believe that tangible assets related to buildings, fixtures, fittings and equipment are under-recorded in CVS's accounts. To recap:

- **Under valuation of listed assets**: There are a number of assets (including buildings and equipment) that have been fully depreciated but are still in use by the business and which are necessary to the operation of the business (which are therefore by definition valued at less than the cost to replace). More generally, the replacement cost of assets is often higher than the depreciated value.[17]
- **Missing assets:** In relation to certain acquired sites, there may be assets that exist but are not recorded, in particular smaller items.

In both cases the value of such missing or undervalued assets will in practice be captured by "goodwill" for acquired FOVPs, but for greenfield sites will simply be missing from the balance sheet.

It is also possible that there are some assets in the asset register that have in fact been discarded or in some cases disposed of – although it is likely that any such errors relate to smaller rather than high value assets: on balance, CVS's view that the reasons for under-valuing fixed assets will outweigh the impact of including some small assets that have been discarded / disposed of. We understand that in light of feedback from the industry, the CMA has signalled it will be seeking further information on the appropriate method of valuation of these assets.[18]

Table 6 below summarises the net book value (both owned and right of use ("**ROU**")) of property, fixtures and fittings, and equipment recorded in the CVS financial information submitted to the CMA for 2021-2023, focusing for simplicity on veterinary sites (FOVPs and referral centres). In discussing these categories with CVS, we have been provided with a more detailed description of which assets sit in each category, as set out in the second column below.

It can be seen that the way CVS categorises its assets does not always perfectly align with the CMA's categories. In particular, fixtures and fittings are in reality combined with "equipment" rather than with "property", and freehold buildings are categorised together with "freehold land" rather than with "property".

17 As CVS explained previously, there is no meaningful second-hand market for veterinary equipment. When assets are replaced, they are generally replaced by new rather than used equipment in line with CVS's strategy of providing the best quality clinical care to animals. This is specifically an issue in relation to PPE, which is held in the accounts at cost less accumulated depreciation, rather than at valuation, in accordance with IAS16, resulting in a book value consistently below replacement cost.

18 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.47.

Table 6: CVS Tangible assets by category

RFI 6 Category	Description	FY2021 (£000s)	FY2022 (£000s)	FY2023 (£000s)
Tangible non-current assets: owned outright				
Land	Freehold land and buildings	[✂]	[✂]	[✂]
Property, fixtures and fittings	Leasehold Improvements	[✂]	[✂]	[✂]
Equipment	Fixtures, fittings, tools and equipment	[✂]	[✂]	[✂]
Other	Motor Vehicles	[✂]	[✂]	[✂]
Tangible non-current assets: right of use				
Property, fixtures and fittings	Property Leases	[✂]	[✂]	[✂]
Equipment	Equipment Leases	[✂]	[✂]	[✂]
Other	Motor Leases	[✂]	[✂]	[✂]

Source: CVS Financial Templates FY21-FY23

The specific assets sitting in each of these categories is important to understand when assessing to what extent these categories are capturing the true value of CVS's tangibles. In particular, for each type of tangible asset there are different potential methods to test whether net book value (NBV) is properly capturing the true value of those assets, and a comparison can then be made between these "modelled values" and the values recorded on CVS's books, to account for the missing element. To summarise:

- The majority of CVS's sites and certain vehicles are leased and the book value of these leases is generally (under IFRS16) captured under "*Tangible non-current assets: right of use - Property, fixtures and fittings*" (description: "**Property Leases**") and *" – Other"* (description: "**Motor Leases**"). In CVS's views these RoU leases should be reasonably well valued under IFRS16 standards, although these valuations may be somewhat conservative.[19]
- There will be some (limited) operational leases that are not currently capitalised at all (again following IFRS16 standards) – and these are discussed briefly in Section 3.1.1 below.
- The remaining sites and vehicles are owned freehold and the book value of these is captured under "*Tangible non current assets: owned outright – Land"* (description: **"Freehold Land and Buildings**") and *" – other"* (description: "**Motor Vehicles**"). These assets are likely to be undervalued and should be revalued as set out in Section 3.1.2 below.
- Where CVS has invested in improvements to re-configure a leased site to operate more effectively, e.g. as a veterinary practice (for example making structural modifications or re-configuring interiors to provide for additional consulting rooms or partitions etc), this is recorded under "*Tangible non current assets: owned outright - Property, fixtures and fittings.*" (description

19 For example, leases are only capitalised to the end of their term, even if there is a contractual right to renew, and ignoring the protections that exist for CVS under the Landlord and Tenancy Act – thereby failing to value these rights.

– "**Leasehold Improvements**"). The remainder of the assets recorded relate to fixtures, fittings, tools and equipment – whether owned outright or leased. As all these assets are the type that are also built up in the development of greenfield sites, we can use a comparison of NBV of these assets for existing sites with the cost of actually creating these assets for new sites, to check the extent to which the NBV values are understated. This is set out in more detail in Section 3.2 below.

In the rest of Section 3 we discuss our proposed approach to valuing these tangible asset categories in more detail. Although our discussion focuses on veterinary practices, as the main element of CVS's business, as noted above there are likely to be substantial missing tangible (as well as intangible) assets across CVS's other business units also – and therefore this exercise will also need to be carried out for other parts of CVS's business.

3.1. Capturing missing land and leasehold assets

3.1.1. Capitalisation of operational leases

We note that the CMA is now also proposing to capitalise operational leases.[20] In practice, the large majority of CVS's sites are subject to RoU leases, which have therefore already been capitalised under IFRS16. However, there are some sites and particularly equipment (e.g. commercial washing machines) that are sourced under operational leases, and we agree that ideally those would also be capitalised rather than treated as opex.

3.1.2. Valuation of freehold land, buildings and vehicles

We also note that the CMA plans to revalue freehold property (which we take to mean freehold land and building) assets on a modern equivalent asset (MEA) basis.[21] CVS does have freehold land and building assets and agrees that many of these will have been acquired years ago, and the value recorded for them on CVS's balance sheet will not reflect their current market value. Therefore, it is indeed appropriate to replace these book values with an MEA value for these freehold properties (land and buildings) – which we understand would most practically be done through the use of an appropriately qualified property agent.

We would also place owned vehicles in this category (which for CVS we understand likely relate to vehicles owned e.g. in its crematoria business or for the use of ambulatory equine and farm animal vets). These are depreciated at **[✂]** per annum on a straight-line basis, and therefore are likely to be undervalued on the balance sheet, as vehicles would generally have a longer useful life than this in CVS's experience. Again, for a proper bottom-up capital base assessment, these would need to be revalued to reflect their economic value.

3.2. Capturing missing building adaptations, fixtures & fittings, equipment and related assets

Once land and buildings are properly valued, and operational leases capitalised, this leaves the remainder of the asset base which covers leasehold improvements (i.e. building costs associated with making a building fit for use as a veterinary practice), fixtures, fittings, tools, and equipment. Based on the descriptions provided by CVS, the total recorded book value of these assets across its 420 veterinary

20 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.45.

21 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.46.

practices (411 FOVPs and 9 referral centres) in 2023 was **[✂]** (and lower at **[✂]** in 2022 and **[✂]** in 2021). This implies an average of **[✂]** per practice even in 2023, and substantially lower in previous years.[22]

One way to estimate the typical replacement cost of these assets across CVS veterinary practices (which forms the bulk of the asset values we focus on here) is to build up an estimate based on *the cost to fit out a typical site from scratch* (based on CVS's experience of greenfield and relocation projects), appropriately scaled up across the sites and depreciated to reflect the average economic life of these assets. In principle, this approach should provide a more accurate reflection of the economic value of the assets CVS has on its balance sheet and also correct for the problem of both missing assets and disposed assets (since these asset register mis-match issues are unlikely to arise in the case of new greenfield sites). It is also a practical approach given that there is no real second-hand market for these fixed assets from which one could obtain replacement cost estimates.

Although in the time available, and in light of the other coinciding submissions to the CMA, CVS has not been able to capture a full list of these costs for its sites, some recent examples that have already been submitted suggest that these costs can be material. Specifically, documents submitted show that Southport Vets had fit out costs of **[✂]** (plan: **[✂]**) and Ambivet Derby of **[✂]** (plan: **[✂]**). These values would need to be adjusted to take account of:

- **Depreciation**: if we assume that the "typical" CVS site is halfway through its life, then we could apply a 50% depreciation,
- Differences in **scale** between these projects and CVS's typical site (e.g. in terms of number of consultation rooms or FTE vets);
- **Inflationary** changes in building and fit out costs over time (to the extent that some of the benchmarked projects may have taken place a few years ago, and given recent inflation, it will be necessary to bring values up to date for any older projects included).

Based on the Southport and Derby examples, it seems likely that the **[✂]** average value for these assets per site across CVS sites may be significantly understated.

Similar issues are also likely to pertain to referral centres, labs and crematoria, as set out in the discussion of ROCE by business unit in Section 2.2 above, and in principle could be corrected through a similar mechanism (at least in relation to crematoria and referral units, where there have been recent relocation and/or greenfield site developments that could be used as a base).

Another potential approach, as the Working Paper notes, would be to rely on insurance values. **[✂]**

4. INTANGIBLE ASSETS

The CMA has noted that the balance sheets of corporate veterinary firms such as CVS can include very high amounts for intangible assets and that these intangible assets include "goodwill, software, and brand and reputation assets such as customer relationships, know-how and trade names".[23]

22 This is clearly approximate, not least due to the combination of referral sites and FOVPs in this total. For the final exercise, this exercise should be done separately for FOVPs and referral units if possible.

23 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.49.

Goodwill is generated on CVS's balance sheet when it acquires a business that has a greater value than the recorded value of assets on its balance sheet. As such it can be seen as essentially a "catch all" for any asset in these acquired businesses that has not been explicitly valued. This will include any missing or undervalued tangibles (as discussed in Section 3 above), but also any intangible assets that are difficult to measure or which generally accepted accounting standards do not allow recognition of, such as reputation, brand, trade-names, people, know-how, customer relationships, training programmes, customer care processes, etc. In relation to parts of the business created from scratch, rather than acquired, these assets will simply not appear on the balance sheet at all.

In relation to goodwill, the Working Paper recognises that *"when purchasing a business, an element of goodwill may represent the value of intangible assets not capitalised on a business's balance sheet"* and that it plans to value any such missing intangibles that *"meet our criteria for recognition, at their value to the business*".[24] 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. According to the CMA, *"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".*[25]

While this kind of approach can make sense in principle (essentially rebuilding the balance sheet from the "bottom up" to ensure that all asset categories are fully understood, and do not incorporate any market power element), there is a real risk that the CMA's approach leads to the undervaluation of assets, and consequently an over-estimation of ROCE. Essentially, any real asset that the CMA's "bottom up" approach does not capture will instead be interpreted as excess profitability and consequently as a "detriment" to consumer welfare. It is therefore very important that any such "bottom up" exercise is comprehensive and does not exclude legitimate assets that would exist in a competitive market. We are particularly concerned that the CMA approach risks under-valuing intangible assets which are difficult to measure.[26] It would be entirely misleading to omit real competitive market intangibles from the assessment simply because we do not have a good way to measure them.

In this paper we set out a potential approach to capturing the value of intangible assets by either (a) modelling the *start-up costs that are incurred when setting up a typical greenfield practice (a "bottom up" approach) or (b) the opportunity costs associated with starting up a greenfield practice rather than buying an equivalent business as a "going concern".* This is a way of quantifying the *replacement costs* involved in building up intangible assets, were they required to do so from scratch (the former based on costs to recreate, and the latter based on a market valuation). The resulting intangible asset will represent the value of the start-up costs that are avoided when a firm acquires an existing practice, and which therefore flows through into how much a firm is prepared to pay to acquire a new site and into purchased goodwill.

We set out this analysis of set up costs in Section 4.1. However, there are a number of other intangible assets that drive CVS's returns but are not captured by an assessment of FOVP start-up costs. These are discussed in more detail in Sections 4.2-4.4 below.

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24 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.55.

25 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.56.

26 We discuss the under-valuation of tangible assets (that, in the case of acquired businesses, would ordinarily be expected to show up in purchased goodwill) in Section 3 above.

4.1. Using start-up costs or losses to value the local brand/ reputation/ customer list intangible

When we consider why groups such as CVS find it attractive to acquire existing FOVPs in addition to developing their own, it is clear that such acquisitions enable them to acquire a bundle of intangible assets that are expensive and difficult to create.

A new vet starting out from scratch must find a good site where there is sufficient demand to support their business, build up a reputation and customer-base (at the cost of staff effort and running with unbilled capacity as they do so), deal with the risks associated with training and retaining a staff of veterinary professionals from scratch, incur the costs of building up customer care and clinical process know-how and bear the costs of financing this capital investment until they generate market returns (as well as bearing the risks that it may not do so). Building up these assets so they can deliver good customer service and consequently build customer relationships not only generates some immediate benefits (of revenues from those initial customers), but importantly lays the foundations to earn greater income into the future (including creating a base of "word of mouth" ambassadors for the business - if the business is run well - that help sustain a pipeline of future customers).

From the perspective of a firm such as CVS, if it can find a mature and profitable vet business at lower cost than the cost (and risk) of undertaking all these activities itself, then it makes sense to do so. Therefore in areas where such opportunities exist, CVS (and its rivals) will seek to take advantage of them (also bringing benefits of economies of scale and scope around centralised services) – while also looking for opportunities to build sites from scratch where it sees an opportunity to do so profitably, despite the costs, time and risks of doing so.[27]

The only significant element of these intangible assets that CVS capitalises separately in the normal course of business is the value of customer lists[28], which does not capture the value of all of these intangible assets. This is because customer lists are valued based on a net present value of future cash flows from existing customers (on a truncated basis), rather than on the basis of the costs to replace all of the intangible assets necessary to support all future revenue flows. The true value of these lists could therefore be greater or less than the value recorded – and in any case is very difficult to separate from the broader intangible value of the business (brand, reputation, local know-how, coherent and established team, etc.).

4.1.1. A bottom-up approach: assessing the costs of starting up a new practice

As noted above, one way to estimate the value of intangibles associated with individual FOVPs is to base the valuation on the *start-up costs that are incurred when setting up a typical greenfield practice.* The Working Paper already recognises 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 (which under the CMA's terminology would include customer lists/patient data records, trade names and know how), using a *cost-based approach*.[29] However, it is inappropriate to focus solely on marketing costs and/or start-up *losses* when performing this assessment as neither of these fully account for the replacement costs involved in establishing the "brand and reputation assets"

27 **[✂]**

28 The CVS balance sheet also records a small amount for Software Costs (e.g. just over [**✂**] in relation to its veterinary services business in 2023, and around **[✂]** across the business as a whole). We discuss this in further detail in Section 4.2.

29 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.60.

and other intangibles associated with each site. It is also inappropriate to focus solely on the loss-making period during which these costs are incurred and assets created: instead one should focus on the longer period of growth to maturity (which we understand to be typically 5-6 years in the case of CVS's greenfield sites).[30]

In summary, we agree with the CMA that it makes sense to use information about the experience of start-ups when trying to estimate the value of intangibles (and that it makes sense to value these assets together, rather than trying to separately assess the value of local brand, reputation and customer lists – given that these assets are all built together by a new practice). However, in our view the correct way to use this information is to assess the costs incurred during this "start-up" phase (i.e. to maturity) of a greenfield FOVP in building up these reputation/brand/customer assets, since this better approximates the costs involved in replacing them.

When a new FOVP is set up (whether by an independent vet or a corporate such as CVS), these reputation and brand assets (including the creation of a customer list) are built up through a number of marketing activities, such as advertising in the local press (articles in local papers/magazines); leafleting; outreach and events; social media campaigns and banners.[31] Direct costs are also incurred through training staff and building up local know-how. However, the cost of building up these intangible capital assets is not limited to the direct costs of these specific activities. In order to build up a mature business, the practice needs to hire vets, veterinary nurses, and other staff to give sufficient capacity to both develop the business and ensure that growing demand can always be met. It also needs to have enough space to house that future larger business (or incur the costs of moving site during the start-up phase, although this is not something that CVS generally does) and enough equipment to meet patient needs as they develop (which means that equipment may not always be fully utilised during the early years of a new site). This can be seen in CVS's business plans for its recent Southport and Derby sites, already submitted to the CMA. Moreover, a new veterinary practice will likely earn lower rates than an established practice (as its customer list will tend to skew to younger animals/new pet owners, and our understanding is that margins on services for new pets such as spays and vaccinations are generally relatively low).

Of course, some operational costs during this start-up phase are incurred in order to serve current demand and generate current revenues. However, some are incurred *solely to support future demand* – either directly (e.g. outreach, training staff, building up local know-how) – or indirectly because they are a necessary practice running cost which is only incurred to support future demand and without which a customer base and other aspects of a successful practice could not be built. These direct and indirect costs to support future demand are part of the costs of building the intangible assets and should therefore be capitalised.

This approach is in line with the criteria that the CMA has set out in Guidelines for the recognition of an intangible asset for purposes of economic profitability analysis. Specifically:[32]

30 For the avoidance of doubt, these start-up costs are not limited to the creation of a customer list, but also to the creation of all of the intangibles we describe above and which the CMA is grouping under "brand and reputation assets".

31 In practice this outreach/events might include running puppy socialisation classes or first aid courses. etc. Vets at new practices will also work on obtaining the relevant accreditations for that practice (with some central support).

32 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.50.

- They are incurred primarily to obtain earnings in the future (as a vet would not undertake these marketing activities and run with such high levels of spare capacity in the normal course of business once established);
- They are additional to the costs necessarily incurred at the time in running the business (simply to serve the customer book at any point in time, the new vet could operate out of a smaller site and with fewer staff: the additional capacity is required only because of the fact that this is an investment that generates future revenues); and
- These costs are identifiable in creating an asset separate from any assets arising from the general running of the business (as absent the plan to grow and generate future revenues, these costs would not make sense to incur).

This conceptual approach can be applied straightforwardly to the start-up P&L of a greenfield site by splitting costs between those that are necessary to generate current revenues (which are "necessarily incurred at the time in running the business" and therefore should be treated as opex), as opposed to those that are only incurred because they are necessary to the creation of the (larger) future business, and can be identified as creating the intangible assets (customer lists, brand, reputation, know-how, etc.) on which that mature business will rely.

A simple way to do this is to look at the development of costs and revenues over time, compared to those of the mature business that is ultimately created. Specifically, we calculate what the practice would hypothetically cost to run if it was solely serving current revenues, at the same productivity level that we would expect to see from a mature vet practice. Conceptually this is equivalent to assuming that the practice can flex costs (e.g. labour, buildings, equipment etc) so that it incurs only those necessary to serve current revenues – as opposed to allocating any staff time or other resources to building a larger future business. We allocate this adjusted hypothetical cost level to opex and allocate the difference between this hypothetical cost level and the actual cost they have incurred to capex.

This is illustrated below for the hypothetical example of a FOVP that reaches maturity over six years, stabilising at revenues of £1m per annum and with costs (including depreciation and amortisation) of £750,000 per annum (**[✂]**). It can be seen that the mature business is profitable, with costs making up around 75% of revenues. However, at an earlier stage of development the ratio of costs to revenues is greater (and in year 1 actually above 100%, resulting in a loss).

As is inevitably the case for a new business, the build-up of costs towards mature levels is faster than the development of revenues. This is because staff costs – which make up the majority of practice costs – are used to build up relationships/new business and sign up new customers, as well as to treat existing customers – and also because facilities will need to be scaled for the volume of business that could possibly arrive, rather than just the expected volume of business, or the FOVP will have to turn potential patients away. In our illustrative example:

- In Year 1, costs are already at 50% of their mature level, while revenues are only at 30% of their mature level. This implies that around 60% of costs (i.e. £225,000) are driving current revenues (i.e. 30% of the 50% - based on the rate at which costs drive revenues in a mature business), while the remaining 40% (i.e. £150,000) are only incurred because it is necessary to do so in order to allow/drive the growth of future revenues in the larger business. To put it another way, if in Year 1 the practice was able to achieve the 75% ratio of cost to revenue that is experienced at maturity, it would only incur £225,000 to do so: the remainder is the unavoidable cost of creating the intangible assets described.
- In Year 2 revenues increase to 50% of mature levels, but costs run ahead to 65% of their mature level. This means that the proportion of costs going to drive current revenues is higher (at 77%:

50% of the 65% or £375,000), but still the remainder (23% or £113,000) is going towards building the future business. To put it another way, were the practice able to achieve the "mature" 75% ratio of costs to revenue, it would incur £375,000 in opex: the remainder is the unavoidable cost of creating the intangible assets described.

- This continues through year 3-5, with the proportion of costs driving immediate revenues growing each year, as the business grows towards its final mature cost to revenue ratio, and customer lists/reputation/brand assets approach their mature state and value.
- Eventually at maturity (Year 6), both costs and revenues reach their mature level, and the intangible asset (customer list/reputation/brand) reaches its mature value. At this value it will still require maintenance (as without further effort it would depreciate over time) – but the business is now in a mature "maintenance phase" rather than an asset-building "start-up phase".

This development is shown in greater detail in the table below.

Table 7: Identifying start-up costs that create an intangible versus those driving current revenues

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Total
Revenue (£,000)	£300	£500	£700	£850	£950	£1,000	
Cost (£,000)	£375	£488	£600	£675	£735	£750	
Revenue relative to maturity	30%	50%	70%	85%	95%	100%	
Cost relative to maturity	50%	65%	80%	90%	98%	100%	
Proportion of costs generating current revenues	60%	77%	88%	94%	97%	100%	
Costs driving current revenues (£,000)	£225	£375	£525	£638	£713	£750	
Cost of developing future business, to be capitalised (£,000)	£150	£113	£75	£38	£23	£0	£398

Source: Illustrative example

In the example above, the total costs to be capitalised are just shy of £400k – with over £300k of that generated in the first three years (after which the ratio between costs and revenues starts to approach its mature state). This reflects the fact that in the early years of a practice there is more spare capacity, so vets, veterinary nurses and other staff will spend more time and use more practice resources building new business. These activities (and the spare capacity to conduct them) will then decline as the practice becomes more established and approaches maturity.

To complete the analysis we would need to add an assessment of financing costs (as the intangible assets created are not productive until the practice activity has increased, and a start-up firm will need to bear the costs of financing those assets until revenue catches up and starts to provide a return on investment that will cover those financing costs). This means that the c. £400k figure calculated above represents a conservative estimate of the capitalised cost of developing the future business and related intangibles.

While in practice the size of the intangible is likely to vary a great deal from practice to practice, (depending on the size and success of the practice and the speed at which it can attain its mature level

or at least, a position where its costs relative to its revenues reach a fairly "mature" relationship) it illustrates that the value of these intangibles can be significant. In 2023, CVS's customer list and goodwill intangible assets recorded on its balance sheet across all its veterinary sites (including 411 FOVPs and 9 referral centres) was **[✂]**, or around **[✂]** per site. The value of intangibles estimated under this start-up cost approach can therefore go a significant way to explaining the customer list and "goodwill" intangibles on CVS's books – even before considering missing tangibles (as set out in Section 3 above) and centrally held intangibles.

Although this illustration relates to a FOVP, in principle the same exercise could be carried out in relation to referral centres, labs and crematoria. We also understand that greenfield FOVPs tend not to include OOH services – but the development of new OOH services will also incur material incremental set-up costs as they are developed and before they reach maturity, which again should be capitalised in a similar manner if a complete view of intangibles is to be obtained. In each case the costs associated with the creation of intangible assets can be isolated by assessing to what extent the operating costs of the years prior to maturity are generating profits *now* (and therefore should be treated as opex), and to what extent they are only incurred because they are necessary to generate *future profits* (and therefore should be capitalised onto the balance sheet).

Clearly such an approach is a simplification, but it does capture the basic components of start-up costs in a relatively straightforward way, and one that is not affected by any market power (as if market power results in inflated prices, then this will be reflected in revenues throughout the period, and therefore cancel out in calculating the ratio between revenues). Indeed, if the entry of the practice intensifies local competition then the approach would be conservative, as the ratio of Year 1 to Year 6 revenues would then overstate the extent to which the practice is running at its full mature rate).

4.1.2. An opportunity-cost approach – how much should CVS be willing to pay to avoid start up costs?

An alternative method to assess the value of the intangible is to look at the *opportunity cost* associated with CVS creating the asset itself (by building a greenfield site) compared to purchasing an existing vet practice of equivalent scale and nature. This is similar conceptually to the bottom-up method above, but looks at the foregone profits associated with building up a practice from scratch rather than buying it, rather than the direct costs involved in that process. The profits foregone by a business choosing to set up a site from scratch, rather than buying an existing site, should be equal to its willingness to pay for an existing site (these lost profits are essentially the opportunity cost of taking the start-up route).

Of course, this type of approach relies on a comparison of profits under two hypothetical scenarios. As such, if prices are inflated due to market power, then this could in principle feed through into an inflated assessment of the opportunity cost of building rather than acquiring a new practice. However, we do not see clear evidence that this should be of concern, as set out above, given that the market is characterised by the constant entry of new independent vets (as well as CVS greenfield projects, for example) and is relatively unconcentrated at a national level.

Moreover, even if the CMA were to find evidence of market power inflating prices, it would still be possible to run an "opportunity cost" assessment of this type, by replacing actual revenues with an estimate of what competitive revenue levels would be (e.g. by restricting the assessment to sites where local concentration levels are low).

4.2. IT systems and software development costs

CVS's accounts as submitted previously set out around **[≫]** of software assets for its veterinary services business, **[≫]** in relation to laboratories, **[≫]** for crematoria, and **[≫]** for online retail, coming to a total value of **[≫]** in the UK business.

- In relation to the veterinary services business, the **[≫]** figure does not reflect the recent transition to **[≫]**. The figure recorded for 2023 will reflect the depreciated value of CVS's previous IT system **[≫]** with a value far below the modern equivalent that has now been put in place.
- In relation to laboratories, again the **[≫]** figure reflects a Lab Management System, which is largely depreciated but still of significant value. This system will soon be replaced by a more modern system (as set out in Section 2.3.1 above) at an estimated cost of **[≫]**.
- In relation to crematoria, **[≫]**, which are not reflected in the figures submitted.
- In relation to online retail, CVS is in the process of developing **[≫]**. While some of the costs of this development process will already have been capitalised in the 2023 figures submitted, others will not.

4.3. Centralised intangibles

In addition to the intangibles set out above, CVS owns valuable know-how and systems at a central level, that help it to run all of its veterinary practices and other activities more effectively and profitably. Some of these can be understood from a review of CVS's recent Quality Improvement Reports – part of an ongoing exercise to maximise the benefits of CVS's scale and expertise across its practices. These projects include, for example:[33]

- **Systems:**
    - CVS's **Integrated Care Council (ICC)**, which has developed a Clinical Governance Framework used to support clinical improvement processes and decisions;
    - CVS's **Clinical Advisory Committee (CAC)** – ensuring for example that new drugs and treatments are quickly understood, with training provided across CVS so that practitioners understand when they should be offered/used;
    - **Small Animal Clinical Improvement Projects**, currently focusing on clinical improvements across brachycephalic obstructive airway syndrome, dermatology (increasing the use of microscopy to offer the right treatments first time) and diabetes (making greater use of a recently validated Diabetes Clinical Score and blood testing to improve the management of diabetes);
    - A recent project in relation to laboratories, ensuring all samples are booked into **CVS's Laboratory Information Management System**, to reduce the potential for labelling errors and maximise the speed with which tests could be booked in and therefore reported back to clients.

33 CVS's Quality Improvement Reports can be found at https://www.cvsukltd.co.uk/investor-centre/results-and-reports/

- **Equipment Servicing** systems: CVS ensures all equipment is kept in full working order and up to date **[✂]**.
- **Health and Safety compliance systems:** CVS also has strong internal compliance systems to ensure that all health and safety requirements are met across its sites and wider business.
- **More broadly** CVS has invested in setting up centralised support systems so that individual practices can benefit from support across functions including HR/staff management (e.g. absence cover), complaint handling, property management, health and safety compliance etc. which have a value not only to individual practices but also the reputation and standing of CVS more broadly.

- **Training:** CVS invests significantly in centralised training and CPD resources including:
  - A **New Graduate Programme** (a two-year structured clinical training programme), which was restructured following a 2021 internal survey and to align with 2021 RCVS Vet Graduate Development Programme (GDP) Entrustable Professional Activities (EPAs) requirements, and a new system to better select new hires and match graduate vets to practices.
  - The development of CVS's **Knowledge Hub**, an online repository of training materials covering topics relevant to all staff (including vets, nurses and support staff).
  - **Critical care training** through a course developed for veterinary staff called ECCelerate, designed to improve performance in responding to emergency/critical cases, particularly in an out-of-hours setting. This is an 18-24 month programme developed by CVS, including five days of practical skills training, online resources, monthly topics and discussion forums led and delivered by CVS vet and nurse trainers.
  - The development of **hands on training** courses for staff, including through its veterinary nurse training centres in Chester, Dereham and Harrogate.[34]
- **Veterinary nurses:**
  - CVS has developed a training programme aimed at providing Registered Veterinary Nurses (RVNs) with the skills needed to take on all clinical tasks they are legally permitted to do – many of which are not covered in typical nursing courses, so is delivered internally through CPD. This makes use of CVS's wet lab and allows nurses to run their own clinics for patients with diabetes or weight management problems, for example. At the end of 2022 over 40% of CVS's RVNs had embarked on this training.
  - More generally, CVS is investing to support the contribution that nurses can make to veterinary care. For example, it recently set up a Nursing Advisory Committee to represent nurses' views more clearly in the firm, and to support the CAC by evaluating new research, treatment and equipment from a nurses' perspective. The Nursing Advisory Committee also reviewed the curriculum for CVS's Nurse Career

34 https://www.chestervtc.co.uk/

Pathway, refining the availability of appropriate training courses, and was involved in CVS's antimicrobial stewardship programme.

- **Research and development:** CVS encourages and rewards R&D efforts by staff through a system of grants (Clinical Research Awards) – funding research done in-house or working in collaboration with universities to generate new knowledge. Projects have included the development of 3D printed surgical guides to support complex surgery, work on antimicrobial susceptibility of common bacterial infections, and assessment of novel biomarkers for disease diagnosis.

While many of these projects may also carry some immediate benefits, most of them have the characteristics of the CMA's definition of an intangible asset – in that they are not *necessary* to the day to day running of the business, but allow CVS to grow new revenue streams and avoid unnecessary costs (e.g. associated with customer dissatisfaction or staff-turnover) *in the future*. As such, they should be capitalised as intangible assets. It is also worth noting that many of these activities simply could not be sustained by an independent FOVP – but are only viable when the future benefits of the investment can be reaped across a large number of practices.

Of course, actually valuing these assets is a difficult task (which is why they are not currently recognised on CVS's balance sheet). However, it is clear that they have real value. To consider just one small example, **[✂]**.

4.4. CVS's wider business

As noted above, the existence of brand/reputation/customer list intangibles associated with start-up period investments will also exist for the wider CVS business (including referral centres which sit within CVS's veterinary services business unit, but also laboratories and crematoria, which are part of separate business units). There will also be intangibles relating to the smooth working together of CVS's various business units – something that must be built up over time. Therefore, if the CMA continues with its plan to look at profitability for CVS's UK business as a whole, rather than focusing more narrowly on veterinary services, then it will be critical to ensure that tangible and intangible assets are fully captured for these wider business activities, and not only core veterinary services.

5. WACC

We understand that for many of CVS's competitors they either have no market WACC (e.g. because they are privately held or small independent businesses), or have a WACC that may largely reflect businesses outside the scope of the CMA's investigation (e.g. the retail business of Pets at Home or Mars' wider geographic and product footprint) – and therefore the CMA may be forced to construct a notional WACC in order to understand the cost of capital that would face their veterinary services business on a stand-alone basis.

However, this is not the case for CVS, which is entirely focused on veterinary services, and has limited activities outside the UK. Therefore in relation to assessing CVS's own profitability we see no reason to deviate from CVS's own WACC, which is audited and is used in the normal course of business to assess CVS's financial performance and the viability of potential investments.

In terms of the CMA's broader market assessment, it will be important to recognise that different firms have different business models, which will entail different access to capital (e.g. reflecting different levels of liquidity) and different levels of risk. For example, as a public company CVS's shareholders would not tolerate the levels of debt burden that apply to some private-equity-owned businesses (who may benefit from a higher proportion of lower-cost debt financing as a result). And CVS will equally have

very different business and financing options compared to a small independent vet. It should not be assumed that there is one uniquely efficient or optimal business model or financing structure that can exist in the UK veterinary market, resulting in a single "optimal" WACC that could be applied across all firms (regardless of their actual financing costs).

6. COST INEFFICIENCY

While we agree that in principle a firm with market power could take the benefit of that market power in the form of inefficiency, rather than higher profits, in our view the level of competition seen in the veterinary market makes this unlikely in the present case. Corporate veterinary services suppliers compete with each other to acquire veterinary sites, and with each other and independent veterinary practices to win new customers. In the face of such competition there are strong incentives to optimise costs in order to provide the services that customers want (and are willing to pay for) in a cost-efficient manner. While cost-inflation has of course been observed in recent years (not least in relation to veterinary professionals' salaries), this simply reflects the increased demand for high quality veterinary services and the resulting importance of hiring and retaining excellent veterinary staff. This is particularly the case given the recent difficulty in hiring new vets and historically high exit of vets from the UK market.[35] Therefore this cannot constitute evidence of inefficiency or any lack of downward pressures on costs.

The Working Paper notes that there are many reasons for costs to vary across locations and businesses. Another critical factor in this market, which is not explicitly mentioned in the Working Paper, is the variation across business models. In particular, independent vets who are looking to build a practice and sell at retirement may also take their compensation in the form of dividends or rent rather than solely salary – deflating operating costs relative to those that would be seen for an equivalent business that was not owned by its vets.

It is therefore not clear to us what "analysis of costs" the CMA has in mind in order to assess cost inefficiency – but it seems unlikely to us that any simple cost-comparison across businesses, sites or regions will provide much insight into the cost-efficiency of those businesses.[36]

7. PROFITABILITY OF MID-TIER AND INDEPENDENT VETS

The Working Paper correctly flags the challenges of measuring profitability (and particularly capital employed) for small independent vet businesses, and proposes to assess profitability for a sample of independent vets, which seems reasonable. However, in our view there will be a number of difficulties to assessing their profitability, in addition to those identified in the Working Paper, including:

- The fact that many independent vets, as business owners, may take some of their compensation in the form of dividends rather than salary. In this scenario it would be wrong (as the CMA suggests at paragraph 4.93(a)) to simply ignore dividends, as these would be reflecting not only the financial risks taken as owner, but also the work done by a vet (meaning salary costs alone would be below those at which a vet employee of similar experience could be hired);

35 For greater details of these difficulties see the RCVS Workforce Summit report of May 2022 at https://www.rcvs.org.uk/news-and-views/publications/recruitment-retention-and-return-in-the-veterinary-profession/

36 CMA Working Paper on profitability and financial analysis (1 November 24), paragraph 4.77 notes that the CMA plans to *"assess potential inefficiencies through an analysis of costs, as well as through a review of internal documents."*

- Some independent vets also pay themselves rent for the veterinary premises – and these rents may not be at market levels;
- In CVS's experience through acquisitions, some independent vets expense personal expenses to their business (including for example personal tax bills or utility bills);
- The fact that some of the businesses selected may be being prepared for sale, and as such may be running with lower than sustainable costs (e.g. fewer staff than are required to run a sustainable business);
- Independent vets may rely on third party operators for e.g. OOH or diagnostic services (potentially at higher cost than in an integrated group);
- Independent vets may not be able to benefit from the procurement synergies of a larger business (although they may be able to gain some of these benefits through buying groups);
- Independent vets may not be as rigorous in meeting regulatory standards (e.g. health and safety or clinical standards) and may not set such high standards for facilities and refurbishments, given the lack of broader brand considerations;
- Independent vets will also not benefit from other economies of scale (for example around centralised training and CPD, managing staff absence, handling customer complaints, keeping up to date with new techniques, equipment and regulations, etc.);
- Independent vets will face different risks and costs associated with setting up a new practice (and may do so at a different scale and pace to that adopted by a large corporate developing a greenfield site); and
- Independent vets will face a different cost (and sources) of capital.

These differences do not reflect differences in competitiveness or competitive pressure faced, but rather different business models used to address the same market. It means there will be a lack of comparability not only in cost structure but also in how costs are recorded. Moreover, these different business models will also be reflected in differences in services offered. For example, the type of centralised services that CVS offers to its practice network to ensure e.g. high standards of training, health and safety, equipment maintenance, etc. will be much more difficult and expensive to achieve at the scale of a single stand-alone practice.

Therefore, while we can see the benefits in undertaking this assessment in order to support the CMA's understanding of the workings of the veterinary market more generally (and particularly differences in the business model of the independent segment), it will be important to capture qualitative information on the points above, in addition to basic P&L data. Moreover, it will not be possible to draw meaningful comparisons between the profitability of these smaller independent businesses and those of the larger corporate providers, given the major differences in service and business model set out above.

8. IRR OF ACQUISITIONS

While the IRR of acquisitions can give rise to useful insights, again the results will require careful interpretation and attention to assumptions. In particular, while IRRs will reflect the actual investment and expected or actual cash flows associated with investments, they do not explicitly take account of the risk associated with those investments.

It is worth noting that CVS undertakes IRR calculations in relation to organic investment projects, as well as acquisitions – **[✂]** it will consider the riskiness of a project in considering whether to go ahead at any given anticipated IRR.